PUBLIC HEARING

before

SENATE LABOR, INDUSTRY AND PROFESSIONS COMMITTEE

Proposed Insurance Legislation and Recommendations

August 26, 1986
Room 334
State House Annex
Trenton, New Jersey

MEMBERS OF COMMITTEE PRESENT:

Senator Raymond Lesniak, Chairman
Senator Edward T. O'Conner, Jr.
Senator Gerald Cardinale

ALSO PRESENT:

Dale C. Davis, Jr.
Office of Legislative Services
Aide, Senate Labor, Industry and Professions Committee

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Hearing Recorded by
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NOTICE OF PUBLIC HEARING

August 18, 1986

The Senate Labor, Industry and Professions Committee will hold a public hearing on Tuesday, August 26, 1986, at 10:30 A.M., in Room 334, State House Annex, on the following:

1. What additional powers does the Department of Insurance need to effectively regulate the commercial insurance industry?

(a) Financial disclosure by insurers (S-2318-Senator Pallone, S-2319-Senator Pallone, A-2404(OCR)-Assemblyman Rafferty).

(b) Additional regulation by the Department of Insurance (S-2402-Senator Cardinale).

(c) Resource requirements of the Department of Insurance to effectively implement the current use and file commercial insurance rating system, along with the additional financial disclosure proposals.

2. Identification of specific problem areas in commercial insurance and proposed solutions.

(a) Commercial rating classifications and the department's ability to intervene in arbitrary rate classifications (Example: van pooling included in the classification for taxicabs and busses).

(b) Directors and officers insurance (Recent changes in Delaware law allowing shareholders to limit the liability of directors).

(c) Insurance contract language (S-2325-Senator Lesniak).

3. Ways to increase the capacity to underwrite commercial lines insurance.

(a) Reciprocal insurers (risk retention, S-2467-Senator Lesniak).

(b) Risk exchanges (S-2439-Senator Cardinale).

*(c) Claims-made policies.

(d) Excess liability fund for governmental entities (S-1718-Senator Lesniak).

(e) Indemnification (A-1990/S-1681-Assemblyman Martin and Senator Lesniak and A-2360/S-2209 Assemblyman Rafferty and Senator Lesniak).

(f) Additional steps to increase capacity.

Testimony will be by invitation only. If you have any questions, please contact Dale Davis, Committee Staff, at 609-984-0445.

*Item added to the agenda

APPENDIX:

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(Hearing Transcribed By J & J Court Transcribers)

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SENATOR RAYMOND LESNIAK (Chairman): I think it will be appropriate, we will all be going to Senator Caulfield's funeral tomorrow and we just recently released a bill of Senator Caulfield regarding licensing of adjusters for claims, for fire claims, and it just brings to mind how dedicated Senator Caulfield was with regard to protecting the public in terms of fire safety. I think we all know what a great guy he was, so I would like to ask us to all stand for a moment of silence for Senator Caulfield.

Thank you. Today's hearing is for the purpose of basically dealing with the capacity issue as it relates to commercial liability insurance. We have pending in the Senate and in Senator O'Connor's Judiciary Committee many bills dealing with tort reform. Based on all of the reports that I have read so far and the studies I have done so far in my discussions with many people, including industry people and regulators, it's quite evident that tort reform alone is not going to be sufficient to solve our problems with regard to the affordability and availability of commercial liability insurance.

In addition, we have legislation pending that will put many demands and additional demands on the Department of Insurance in a regulatory capacity. So for that reason we will be having this hearing to deal with a multitude of issues in that regard.

The first person here to testify, and I want to thank him very much for coming, will be Commissioner Kenneth Merin and/or Jasper Jackson -- that's what my notes say right here -- from the Department of Insurance. Welcome Commissioner and welcome Jasper. Do you have an opening statement?

C O M M I S S I O N E R K E N N E T H D. M E R I N: I have no formal opening statement, Senator. As the members of this Committee are aware, I appeared before you up in Elizabeth a few weeks ago and I have--

SENATOR LESNIAK: That's your opening statement?

COMMISSIONER MERIN: That's the opening statement from

Elizabeth. We have copies of that opening statement which addressed basically the same subject area and we also have provided some listing of actions taken in other states in the insurance rate-making area. Just a summary of steps that have been taken or are being considered. I'm aware that you have several questions that you want to try to discuss today and Deputy Commissioner Jackson and I will do our best to answer those questions.

SENATOR LESNIAK: Okay. I think that we ought to best start off with the disclosure bills that we have pending that are in this Committee, both sponsored by Senator Pallone and Assemblyman Rafferty in the Assembly. In whatever form they ultimately pass and get signed into law, they will put additional demands on the Department, additional demands on the industry, and responsibilities on the Department in terms of what are you going to do with that additional disclosure? Are you prepared to handle it and what do you see as the results of that? Basically just in general I would like you to address those issues.

COMMISSIONER MERIN: Okay. In terms of the powers and the authorities of the Commissioner of Insurance in the State of New Jersey, they are among the broadest and most comprehensive powers of any insurance commissioner in the country. So we have very broad powers right now. One of the problems has been, not only in New Jersey but in many other states, that insurance commissioners and insurance departments have not been able to exercise some of the authority that they do have because of a variety of reasons going towards either lack of desire, incentive, or capability to regulate the insurance industry.

I think that the bills that you've mentioned are good bills because they compel the acquisition of certain types of data. The concern that I have voiced many times over the last couple of years is that right now our Department of Insurance is not capable of utilizing all the data that we either could get right now or would be required to get for those bills. We would not be able to utilize that data to the fullest extent possible.

We are in the process of improving the Department in terms of computerizing the Department, and we think that probably prior to the end of this decade we will be in a position to utilize the data. So I guess that's a long way of saying we are supportive of the legislation -- the proposed legislation -- with the caveat that we want the members of this Committee to understand that it will be some period of time before we'll be able to fully and effectively utilize the data.

SENATOR LESNIAK: Are your current personnel needs insufficient, sufficient, or is it just a institutional type of time lag required to get programs organized and constructed?

COMMISSIONER MERIN: I think it's a combination of those things, Senator. The Department is moving onto computerization. We have gotten to the point right now where we're about to hire a number of people to start putting data into the computers. We've exhausted the capacity on our PCs that are in the Department and we're developing a process that will allow us to use the Department of Treasury mainframe computer. So we are acquiring the information right now. That process is ongoing.

In terms of the staff that would analyze this data, I have sufficient budgetary capability right now, this fiscal year, thanks to the generosity of the Legislature, to hire somewhere, I think, between 25 and 30 people. What I am trying to do is get good people. I don't want to go out and just hire bodies to fill up the Department. We're looking around trying to get some very good actuaries, to get some very good technical people that can support the Department. Again, I imagine in the next couple of years the types of personnel that we need or will need will change as we get more of that computer capability. So I think we are moving as quickly as possible to staff up as we should be.

SENATOR LESNIAK: But this disclosure law will require companies to begin giving you this data immediately. Is this just going to be piled up in a corner of a room? Not give you some discretion in terms of phasing it in if it's not going to be

of any use?

COMMISSIONER MERIN: Again, I'm not-- I can't say that I'm aware of the specific phase-in of the law or how quickly the law would take effect. I think that there is some discretion vested in the bill or in the bill which vests the Insurance Commissioner with the authority to exempt certain lines from filing.

I think that I would like to have some legislation take place basically because we do have a need, we do have a desire for information. I think that as we improve the Department we will be able to get the data that we can use, we can ask for that data. That way we won't have to come back to you year after year saying give us this now, we're ready to do this now. I think it's a good thing to go ahead and give us the powers and to compel us, to compel any Insurance Commissioner to get that data. That's fine. I just want to make sure that the Committee understands and that the Legislature understands that when you pass this law we're not going to have the instant capability of responding and that, in my opinion, we can fully make use of that data -- we'll be able to fully make use of it by 1990 or so.

SENATOR LESNIAK: Well, do you feel that there's enough discretion in the law that if there's data that's required to be reported to you that you can't do anything with at the present time or at that time that you would be able to not require that information to be produced until you can do something with it?

COMMISSIONER MERIN: I have been told that there are provisions in the bill which authorize the Commissioner to exempt certain lines from reporting for a variety of reasons. I would suggest perhaps-- It gives me the authority to exempt for up to three years, I'm told. And I would say that there are sufficient personnel in Legislative Services that if you agree with my concerns then perhaps that provision might be modified, but I'm told I do have that authority to exempt for up to three years.

SENATOR LESNIAK: In reference to the way you have to

structure your analysis of this information and your data base management, will you be able to put, for instance, a program together for one particular line with this information? Start that way and phase in the different lines, or will it be a situation where you really can't structure the data base management so that it wouldn't be -- you wouldn't be ready to deal with it really effectively at all until the entire system is in place? Do you understand what I'm--

COMMISSIONER MERIN: No, I think we can do it line by line. As a matter of fact, the projects that we're doing right now, the FEMS project, the Financial Examinations Project, the ARMS project, the Actuarial Project, is proceeding in the development phase and we are setting it up so we can look at different lines of insurance.

DEPUTY COMMISSIONER JASPER JACKSON: Also, one of our problems, one of the reasons we would have difficulty in dealing with all the information that the two bills call for now is because we do not yet have a standard filing format and we have not developed preferred standards on rate-making methodologies by which all of this data would be utilized or reviewed or evaluated. We're in the process of doing that now. We started with private passenger automobile. We moved on to the homeowner's line and we're now considering some of the commercial lines so we would be able to phase it in line by line. Our difficulties is, and what the Commissioner wanted you all to understand, was that if you pass and enact a law we would not be able to take it all at one time and utilize it, but we will be able to use it and phase things on line by line over time. The three years delaying factor is probably enough time.

SENATOR LESNIAK: Moving on to other issues that are of concern to me with regard to capacity, there have been many states that have adopted the claims made form I guess in total across-the-board. There have been other states that have adopted the claims made form on particular lines.

(Pause while Senator Lesniak speaks to Senator Cardinale

privately)

SENATOR LESNIAK: Getting back to the claims made form-- But New Jersey has not adopted it in total and I think you're probably right on that. What lines have you allotted to be used?

COMMISSIONER MERIN: None.

SENATOR LESNIAK: None? Well, I thought professional liability?

DEPUTY COMMISSIONER JACKSON: No, not yet. I think that what's occurred with that claims made forms of all sorts and types are primarily being utilized right now in our surplus lines market. But we have not yet approved the new claims made forms that have been proposed by ISO and most of the other carriers because they are somehow tied or related to the ISO form yet.

Our problem being that they characterize it as a claims made form. We don't know what category it falls in. It does not coincide with any of the traditional definitions of the term "claims made form" because it gives the insurer the ability to do a number of things, which if they exercise the various options that they have in terms of moving certain dates that determine whether you have coverage or not for certain types of events, lasering out certain types of events, and at the same time provide very little prospective coverage, we're not sure how much coverage prospective insureds or actual insureds would be left with. So we've been very careful about what we communicated to the ISO representing the companies that we would approve. We're still attempting to negotiate with them something that we can live with and something we think would be in the public interest in this State.

SENATOR LESNIAK: Were you talking about something that you could -- negotiating the particular claims made form and then deciding what lines that would apply to, is that correct?

COMMISSIONER MERIN: The claims made form has been around for some time and it's gone through a lot of refinement in the last couple of years trying to make it better, trying to make

it more protective of the consumer. That's something that the National Association of Insurance Commissioners is working on, the industry has had several committees working on, and I think everybody agrees that the garden variety claims made form that is being pushed right now is a lot better product than that which had first been proposed a couple years ago.

It's also understood that right now there is a capacity problem in the insurance industry and it is expected that a claims made form will allow the companies to make certain judgments in certain lines and to write lines they would not otherwise write.

SENATOR LESNIAK: They don't have to reserve as much when they use the claims made form.

COMMISSIONER MERIN: Right, because they're adjusting the price every year based upon things that they can forecast as to what will happen in that year, since the claims made form covers claims made during the policy year rather than--

SENATOR LESNIAK: Occurrence.

COMMISSIONER MERIN: Occurrence form. There are several concerns that I have. And without getting into the question of who is right and who is wrong on these issues, they are issues. There have been statements made, allegations made by the insurance companies that the judiciary has expanded the scope of the occurrence forms through various rulings. That same thing could happen on a claims made form. What would be the impact of that, vis-a-vis the impact that they're complaining about on the occurrence form? There's a problem, one type of liability insurance covers insurance agents--

SENATOR LESNIAK: But isn't that their problem? I mean, that doesn't run a risk to the consumer or to the public, does it?

COMMISSIONER MERIN: Right, but the purpose in having--

SENATOR LESNIAK: They're taking that risk.

COMMISSIONER MERIN: Yeah, the purpose in having a claims made form is to make the product more available and I

think that if we approve a claims made form and then there's a decision down the road someplace, a year from now, two years from now, the whole virtue of the claims made form could be very short-lived, and then we have all sorts of questions because there are a lot of policies out there.

One of the types of -- lines of insurance that's getting very expensive right now is errors and omissions for insurance agents and producers. The problems that we would get into in those lines where you have an agent that's selling a product to a commercial insured, if the agent -- if the insured has a problem the insured can go back and say the insured didn't explain this or that. I think a claims made product is a lot harder for a producer to explain than a per occurrence form. Neither is easy, but the claims made I think is a lot harder. I think there is going to be an impact on the errors and omissions rates there.

If you look around the country, some states have approved claims made in all lines. Some states are only approving it in a couple of lines. At the same time as the claims made form is being approved around the country there are a lot of actions being taken by various legislatures in the area of regulating the insurance industry and also in the tort reform area. I know there are quite a few measures that are sponsored in this body as well as in the other house. My objective or my inclination is to approve the claims made form to the most limited extent possible where I can say if I don't approve it, if I don't let it be sold in New Jersey there are lines of insurance that are not going to be written.

My basic gut instinct based upon what I've read is that the claims made form is an inferior product compared to the per occurrence form. I think it's probably necessary in some lines, but I would prefer to see what legislation is enacted here in this State and then make a decision on what lines of insurance will not be sold or it will be just ridiculously expensive if we don't do claims made form. So when we do something it's going to

be as limited as we can possibly get away with.

SENATOR LESNIAK: Jasper, you mentioned it's used for surplus lines. Is that because we don't regulate the form filing for surplus lines?

DEPUTY COMMISSIONER JACKSON: Yes, that's because we don't regulate them. We have the power to regulate them, but we don't because the concept or philosophy behind surplus lines is that the coverage is not really being written within the State per se. It's that coverage that the admitted companies and authorized companies, meaning the domestics, for some reason will not write. So in those instances we permit those lines to be exported by surplus lines carriers to other carriers who will write it, and since those companies are not admitted, nor authorized, nor subject to our regulatory oversight we have not done anything with respect to developing standards concerning the forms or the rates that they utilize.

COMMISSIONER LESNIAK: How is the surplus lines defined? You pass a regulation saying this line is not being written in New Jersey, therefore it's authorized to be written by a surplus line, or is that determination just made out there in the public by somebody not being able to get the insurance?

DEPUTY COMMISSIONER JACKSON: No. Every year we hold a hearing that is designed to determine those lines that admitted or authorized companies are not writing, and attempting to come to understand the reasons why they're not writing it. And if we, once we determine that they're not writing it, and we develop a factual base that convinces us that that situation is going to continue, then we publish what we call an exportable list. And that list becomes available to all the surplus line agents and brokers doing business in the State and that means that these are the coverages that we have determined that there's no available market for in New Jersey and they can write, place these coverages with companies admitted in other states or jurisdictions. They become the surplus lines carriers.

SENATOR LESNIAK: And that approval is good until

changed or is it for a particular period of time?

DEPUTY COMMISSIONER JACKSON: It's for an annual period. We have a hearing every year to determine whether or not we should continue with the existing list or in some manner modify it.

SENATOR LESNIAK: How many lines are currently identified as surplus lines? I'm not going to hold you to this.

DEPUTY COMMISSIONER JACKSON: It's a good number. I would say there are at least 30 some lines on the list, probably higher than that.

SENATOR LESNIAK: Okay. Can you give us some examples?

DEPUTY COMMISSIONER JACKSON: Some examples would be director and officers' liability, inland marine, liquor law liability.

COMMISSIONER MERIN: The list has not expanded that much. That's not a function of the current crisis. There are certain lines that are just inherently riskier or not dealt with by most of the admitted companies. Lloyds of London and other foreign insurers, various surplus lines companies, like Novastar (phonetic) which went under, deal in specific lines and it's not variable that much every year as to what's being written and not being written.

SENATOR LESNIAK: Well, public entity insurance is covered then under surplus lines, municipalities?

COMMISSIONER MERIN: Yes, surplus lines insurers write public entity insurance.

SENATOR LESNIAK: Okay, so basically your determination is not that no domestic insurer will write it but that not too many would, is that correct? I mean there are companies writing municipal insurance.

DEPUTY COMMISSIONER JACKSON: Yeah, but there's not--

SENATOR LESNIAK: But in a limited amount.

DEPUTY COMMISSIONER JACKSON: A limited amount, yes. It's not necessarily that no one will write it. It's either that no entity will write or that there's very little -- or there are

very few companies or other types of entities interested in writing.

SENATOR LESNIAK: Are day care centers surplus lines? Has that been identified as surplus line coverage?

DEPUTY COMMISSIONER JACKSON: I don't know about historically, but it's on the list this year.

SENATOR LESNIAK: It is on the list this year. Okay. Of the surplus lines, do they generally use the occurrence form or the claims made form or is it random?

DEPUTY COMMISSIONER JACKSON: I think it's random, but they have the ability to use whatever they choose. It's whatever the market will bear. They use what they call-- Most of the carriers now on the lines with the latent personal injury exposure, meaning the lines where the claims may not arise, they may not be-- A claim may not arise until 10, 20 years after the event. They're certainly using claims made forms. The problem is that what they define as a claims made form, what differs is in the foreign claims made form are all radically different. Some provide what would be viewed as good coverage and some provide almost no coverage beyond the annual life of the policy.

SENATOR LESNIAK: So a day care center can go out and get insurance coverage through a surplus lines carrier which has basically whatever form the current circumstances they want that coverage would entail?

DEPUTY COMMISSIONER JACKSON: Yes.

SENATOR LESNIAK: The reason why I ask that question is I have been getting letters from my district, my city, regarding day care centers and Continental's proposed claims made form that has not been approved by the Department.

DEPUTY COMMISSIONER JACKSON: Yes.

SENATOR LESNIAK: My concern is if they are now getting coverage or can get coverage through a form that you have nothing to say about or have chosen to say nothing about, properly so. What's the problem with the proposal before you where you do have some regulatory authority in terms of what shape that is?

COMMISSIONER MERIN: Well, the proposal that's coming from Continental, I think it's joint Continental and one other company proposal, is that they want to exclude child abuse from their policy. Continental is an admitted company, it's not a surplus lines company. When you're talking about surplus lines companies you're talking about a whole different regulatory system. We in New Jersey are fortunate. We're the only State in the country that has a guarantee fund for surplus lines insurance which I think passed the Legislature unanimously a couple of years ago, and that's operating very well right now.

But usually companies that are surplus lines companies don't provide that kind of comfort and guarantee people beyond that because we do have that in New Jersey, right now we do have a guarantee fund. States across the country just do not regulate surplus lines companies the same way they do admitted companies. We don't have the capability to monitor the way they service policies as well. We don't have the ability to monitor the way they respond to claims. If Continental's proposal -- and again I think it's a joint Continental and one other company proposal -- it's a deviation from the standard that admitted companies have been held to.

Interestingly, I spoke to the insurance commissioner in one other major state just yesterday who has not taken action on a similar proposal, or on that proposal by the same company. And he expressed the same concerns that we had. He's holding a meeting today where he's going to deny that claim. We denied Continental's application June, I think June 19, June 12th, something like that. And this other major industrial state is going to take the same action today.

SENATOR LESNIAK: But are day care-- It's the day care center in Elizabeth that keeps writing letters -- either then going without coverage so therefore they don't have not only insurance coverage for child abuse or anything else and/or are they going to a surplus lines carrier and getting coverage but doesn't include child abuse and maybe even has even worse claims

made?

COMMISSIONER MERIN: I'm not sure what they're doing. If you want to have that day care center write us a letter or talk to us, we'd be glad to check into it, but there is a MAP setup right now -- Market Assistance Plan -- which does cover day care. We do try to find coverage for day care centers and we have been successful in-- There are 16 applications that have been made to the MAP so far, and of those 16, 13 have been placed in the day care area. So we have, I think, a pretty successful way of handling that type of coverage right now. So before approving a policy that's going to exclude something which we feel is very important, we're having very good success with our MAP right now. We prefer to continue along that direction.

SENATOR LESNIAK: Again, what if-- I mean, these things are in isolation. They have to be viewed with everything else. What about for those three centers that can't get coverage through the MAP? What happens to them? Wouldn't they be-- They'll probably have to go scurrying off to a surplus lines carrier that--

COMMISSIONER MERIN: I'm informed that those three that have not received placement were just received in the last week. The others were received-- The MAP went into operation early in June and in the last seven weeks has placed 13 so the three that were placed in the last week, we hope to get coverage for them.

SENATOR LESNIAK: Is Continental and whatever joint venture they have in this filing, do they participate in the MAP program?

DEPUTY COMMISSIONER JACKSON: Yes. I think that the problem with Continental is that it's not that we're unwilling to entertain the notion of a child abuse exclusion, it's just that Continental's went too far. Such as, you know, an exclusion that goes to something like sexual abuse that's a criminal act, we would never compel an insurer to cover a criminal act. But their exclusion just goes much too far. When the market is operating any where near normal and you have admitted carriers offering

coverage along these lines then it brings the surplus lines insurers into check somewhat also. And we think that that will happen again also. As we've indicated, we have not taken steps to regulate the forms in the surplus lines market in the same manner in which we do it in the admitted market, but it may come to that. The entire NAIC is now looking at everything that has occurred during the current crisis and have noted that an admitted carrier in New Jersey will not write lines that it writes as a surplus lines insurer in California, and vice versa, and are now giving thought to the notion of developing minimum policy standards for surplus lines carriers and have all commissioners enact them so that you get more control over what surplus lines carriers do, can do, and cannot do. So what I'm saying is hopefully the situation we're dealing with today won't always remain the same.

SENATOR LESNIAK: You're going to have to excuse me. He was talking in one ear and I can't hear out of this ear so--

Moving on to another subject, if I may, again dealing with capacity issues, Senator Cardinale has a proposal concerning the risk exchanges which operate in New York, Florida and I believe Illinois, which would authorize them as surplus lines in the State of New Jersey. Are you familiar with that proposal?

DEPUTY COMMISSIONER JACKSON: Yes.

SENATOR LESNIAK: How do you feel about that particular legislation, or that concept? Forget about the legislation, the concept.

COMMISSIONER MERIN: We don't have, I think, a problem with risk exchanges per se. I think a couple of those exchanges, New York and Illinois, I'm not sure about Florida, do operate in most states. There is a problem, I would think, about how they are permitted to operate. One of the most basic questions in dealing with the admission of any insurer is to make sure that that insurer is solvent and that the insurer will have enough money to pay off its obligations. If the exchanges are admitted as surplus lines companies as opposed to admitted companies or as

opposed to some other form of admission, we do not have the control to make sure that the exchanges are as solvent or have the moneys--

SENATOR LESNIAK: You don't have control over the surplus lines either.

COMMISSIONER MERIN: That's correct.

SENATOR LESNIAK: But you allow them.

COMMISSIONER MERIN: The surplus lines companies that are admitted in New Jersey are not controlled to the extent that the admitted companies are. If you remember, when you enacted the surplus lines guarantee fund a couple of years ago, there was a great to-do about how the surplus line market was going to pull out of the State of New Jersey. And we did lose about one quarter, I think, of the surplus lines coverage. Those that are left for the most part we have much greater confidence in their ability to remain solvent. I guess it's a less known item.

SENATOR LESNIAK: What Senator Cardinale's bill does is admit the risk exchanges on the same basis that the surplus lines are -- admit is the wrong word to use -- are allowed to do business.

DEPUTY COMMISSIONER JACKSON: Yeah. See, I think that we talked with both Illinois and New York exchange. They want to be admitted on a direct basis. In other words, they want to become admitted carriers. They're not--

SENATOR LESNIAK: Don't you think they should take one step at a time maybe?

DEPUTY COMMISSIONER JACKSON: Well, maybe so, but they're seeking to do business on a direct basis in admitted sense of the word. Of the problems-- Well, one, we're not sure that we actually need additional authority to admit them to permit them to do business as surplus lines carriers. We are now surveying the law because there are a number of provisions in the law that permit insurance exchanges to operate. We're just not sure that the New York insurance exchange and the Illinois insurance exchange are those types. For instance, the New York

exchange and Illinois exchange are syndicates of companies. It's not a number of companies, say two, three, or four companies joined together to do business as one exchange. There, the exchange is composed of groups of companies syndicated doing business. And you get into a lot of questions as to who's ultimately responsible for what, under whose name are they doing business, and so forth and so on. Even if you admit them as a surplus lines carrier, if we permitted them to operate as surplus lines carrier with our Surplus Lines Guarantee Fund Act, there are a lot of issues around how they would be assessed under that Act since they're not a company. They're not even a group of companies doing business joined into one exchange. They're syndicates of companies doing business on the exchange.

SENATOR LESNIAK: But if you authorize that under the legislation they would be taxed similarly.

DEPUTY COMMISSIONER JACKSON: Yeah, they would be but each company? Each--

SENATOR LESNIAK: Well, isn't it on the basis of--

DEPUTY COMMISSIONER JACKSON: --each syndicate?

SENATOR LESNIAK: It's on the basis of the premium.

DEPUTY COMMISSIONER JACKSON: Or the entire exchange?

SENATOR LESNIAK: Well, it's on the basis of the premium that they write. They would have to decide.

DEPUTY COMMISSIONER JACKSON: No, but first that's an up-front assessment against the insurer itself and then after that--

SENATOR LESNIAK: Well, you wouldn't want the assessment to be against the whole -- each individual group, do you?

DEPUTY COMMISSIONER JACKSON: Well, no, I would not want it to be but--

SENATOR LESNIAK: You don't assess shareholders of surplus lines companies on each individual shareholder. Risk exchange is just a bunch of shareholders forming one company.

COMMISSIONER MERIN: I guess the--

SENATOR LESNIAK: Well, you may want to.

COMMISSIONER MERIN: The concern we have about exchanges, it's not a predilection or a firm desire to oppose their entry into New Jersey. The exchanges are not going to write all lines. They write certain lines. I don't know whether that, their entry is necessary to provide extra capacity in New Jersey for those lines that they would write.

There's also the question of how would they be admitted? You mentioned that Senator Cardinale's bill calls for their admission as a surplus lines company. Deputy Commissioner Jackson has indicated that they themselves might prefer admission as an admitted company, which would give us greater control over that company. It's very important to remember that when an insurance department anyplace in the country decides to admit a carrier or decides to permit an entity to write insurance there is a great concern about solvency. There are a great many companies, domestic companies in New Jersey, companies around the country, that are in financial trouble. And what we're looking at right now is a number of proposals on a State and Federal basis to expand the number of entities that might write insurance so that there might be more capacity. The whole effort in Congress regarding risk retention groups is oriented towards providing more capacity. What the National Association of Insurance Commissioners is concerned about is the solvency, the ability of those entities to pay the claims when they come due.

SENATOR LESNIAK: Well, let's talk about risk retention groups for a second, if we may. Do we allow-- Is there any prohibition against companies getting together and forming their own risk retention group in the State of New Jersey? Yes, right? Because then they're operating as insurance companies.

COMMISSIONER MERIN: The only type of risk retention that's authorized under Federal law is pharmaceutical companies were authorized in the early '80s I believe. Products liability, I'm sorry, in the early '80s to enter into risk retention groups.

SENATOR LESNIAK: Now, my problem is General Motors can

self-insure themselves. They're allowed to do that under the law. Ford can self-insure themselves. They're allowed to do that under the law. Why should we preclude General Motors from joining with Ford to form a risk retention group? What's the risk? What's the danger to the public from that happening? I picked a good example, right?

COMMISSIONER MERIN: I want to be careful in phrasing my answer not to impune the integrity of any particular corporation or state. And I'm--

SENATOR LESNIAK: But if they are already self-insuring, which they can do, you can't stop someone-- Unless there's an insurance requirement, like auto for instance-- You can't stop somebody from self-insuring. If we don't mandate insurance, they don't have to have it. So why can't I, if I'm a tavern owner, join with the Tavern Owners Association and pool our risk if I'm going to be bare anyway?

COMMISSIONER MERIN: Okay. Again, this is difficult without getting somebody upset. I think there's a question as to who is going to set the rate. In other words, let's say everybody around here down on -- all of us own our own tavern and we set up a corporation, we have an insurance entity that's set up in another state -- and I will not name this state where it's set up -- but that state has a very loose system for controlling companies. That retention group decides that if each of us tosses in 100 bucks we have enough money to self-insure for whatever the claim limits might be. And let's say it's a $10,000 limit. You can set up a situation in which the numbers are going to be so insufficient to pay potential claims that when the claim occurs -- when, let's say, there's a claim against Paul's Tavern. Paul will not have the ability to get enough money from the risk retention group. The person that's suing Paul may or may not be satisfied by the value of his tavern. If it's mortgaged to the hilt, somebody else has a claim on that--

SENATOR LESNIAK: But if Paul doesn't have insurance to begin with what's the problem, number one, and number two, we're

talking about businesses. Can't businesses take care of themselves? Do we need government to protect them from themselves? They've got to make the initial decision whether to pay for the insurance, if they can get it.

COMMISSIONER MERIN: I think the answer to the last question is, "Yes." I think that, and I don't want to be flip in answering that question, but I think in a lot of ways a lot of businesses don't know a great deal about insurance. I think if you-- That could be said for some of the larger corporations in the country, but I think it's primarily true for a lot of small businesses, and most of the jobs, most of the employment in New Jersey, as well as most other states, is small businesses and not the large corporations.

SENATOR LESNIAK: Actually it's probably true for most of the big businesses as well from what I can see. But, nevertheless, nevertheless--

DEPUTY COMMISSIONER JACKSON: Well, one of the problems would be, you know, if you're talking about a risk retention group that's going to be comprised of General Motors and Ford and Chrysler, perhaps there is no problem. But if you're talking about a risk retention group that is going to attract numbers of Mom and Pop type businesses and medium-size businesses, there is a problem. And the problem is one, as the Commissioner just said, if they're not capitalized properly they're not going to have sufficient funds to -- they're not going to have sufficient funds to make good on their claims. Yet, they're going to make payment into a fund for that purpose and they're going to be looking for something. To the extent that that fund is incapable of satisfying their claims, then their assets are going to be subject to risk.

And then they will, depending upon the judgment and the success in attaching it, then they will be out of business. When they, say, the way the risk retention groups are being set up, there's no doubt that they will be in direct competition with insurers. And as the Commissioner observed, there will be a lot

of purchasers of that product who will believe that purchasing it from that group is the same thing as purchasing it from brand name reputable insurance firm that has been on line for perhaps a century.

COMMISSIONER MERIN: If you look at the cash flow, the whole cycle phenomenon that everybody has gotten informed about in the last year or so, how the insurance companies got themselves into this hole, where they constantly underpriced one another and then all of sudden, when the interest rates dropped, they didn't have enough money so they started raising rates to get back to where they were before the downwards cycle began. If you look at that situation, you take a look at the risk retention group, which is not under the Federal proposal going to be regulated anywhere near as closely as insurance companies are, it seems like we're trying to tighten up on our regulation of the insurance industry. No insurance commissioner that I know of knows how to control the cycle, but everybody realizes that that's the objective, that's what we should be aiming towards. What we're doing is setting up a system where we're not going to be able to control groups that deal in certain types of insurance. The risk retention groups will be selling a product which is expensive right now, in many cases it is available but it is extremely expensive in certain lines, they'll be selling that at a lower price. In other words, they're going to be lowering it to, perhaps, to an unrealistic level. We know that from previous cycles you can have capacity disappear, capacity is restored, capacity disappear, capacity is restored. Once capacity is restored, as it certainly will be, we're going to have retention groups set up so that line will not be involved in that whole up and down cycle, but they're going to be out of the traditional insurance mechanism. We will have less control over them and there will be as sure as any of us sitting here there will be problems that develop. We have written to the Legislature, the Federal Legislature and indicated some various concerns we have about the risk retention groups and again it all

revolves around the question of solvency. We don't want to create another monster. We've got one monster on our hands right now and we prefer not to have a lot of little ones running around that we can't get ahold of.

DEPUTY COMMISSIONER JACKSON: We don't say prohibit them. We just say if you permit them, give us enough oversight to insure that they're going to be solvent operations and to insure that they're dealing with the various entities, associations that they're going to offer coverage to in an equitable and fair manner. Otherwise there are going to be problems with them going under. And as the Commissioner just said they, themselves, can fuel another cycle because ultimately when they come on line they're going to be offering coverage, they're going to be seeking to spread the base of their membership. They're going to try to draw others in and their calling card is going to be that, "We can do it at a cheaper price." The established insurance market, if it is interested in writing those lines, and does not want to lose its market share, its premium volume, is going to cut prices to match and we're going to be off on another cycle all over again and the risk retention groups will be part of it.

SENATOR O'CONNOR: Mr. Chairman?

SENATOR LESNIAK: Yes.

SENATOR O'CONNOR: Just stay on that for a second, if you will, Mr. Jackson. The provisions that are in the Lesniak bill, are they-- Do you feel that they give you enough oversight to do the job that you're talking about?

SENATOR LESNIAK: You haven't looked at it yet.

DEPUTY COMMISSIONER JACKSON: You got me. I'm not familiar--

COMMISSIONER MERIN: Senator, which bill-- Is that the exchanges or--

SENATOR LESNIAK: The risk retention bill.

SENATOR O'CONNOR: 2467.

COMMISSIONER MERIN: I really can't say that we've

reviewed it closely enough to-- Our comments were more directed towards the Federal proposal.

SENATOR LESNIAK: That's a very good question that Senator O'Connor asked. Could you come back with us after having looked at both my bill and Senator Cardinale's bill with--

COMMISSIONER MERIN: We'd be happy to.

SENATOR LESNIAK: I would look at it another way. I would think that maybe these groups can modify the cycle by bringing capacity when no capacity exists.

DEPUTY COMMISSIONER JACKSON: Oh, they will. They will help increase capacity and they will help increase competition.

SENATOR LESNIAK: You do broach a-- This is probably the first time ever I've been able to see where competition may not be beneficial to the public. I have a very difficult time accepting that -- still don't accept it. And where price regulation may be beneficial to the public. I'm still not ready to accept that because it has never worked yet and the only area that-- Not the only area. I mean just look at what we've done with solid waste, for instance. I mean we've regulated solid waste hauling and disposal pricewise because the lack of competition, because there was control, markets were controlled by organized crime. And here we are 15 years later and the situation hasn't changed. My concern is that when we start talking about cutthroat competition and prices going down, when prices go down, that means consumers are paying a lot less. I'm not all that upset about consumers paying less for a product.

COMMISSIONER MERIN: But in this case, Senator, where you have cycle like this in the insurance industry, people buy insurance so they can bring an element of predictability into their business. There are a lot of things that are unpredictable. They might have accidents, they might have injuries, they might have things that break down, but they want to pay a certain amount they can factor into their budget year after year to protect themselves against those contingencies. What we find now is that many businesses are seeing that the

greatest variable, the one thing they can't predict, is the cost of the insurance. They can predict everything else okay, but they're now bouncing around on the insurance cost. I think that in terms of setting rates or regulating rates on insurance, I think that's a very difficult thing do to and I don't think that we have the ability, I don't think that most departments in the country have the ability to regulate rates. Nor do I-- I think I agree with you, nor do I want to. But I think it's incumbent upon any regulatory system to make sure that companies are solvent. It's the most difficult thing in the world for an insurance commissioner to say to a company, "We're not going to let you lower your rates; we're not going to let you sell this particular product even though you want to" because we know that that particular company is not in a financial position to do it. That's what they're trying to do, in many cases, is to take a weak position to build up a lot of capital to pay claims that they know are occurring. It's something that they're not doing because they're any old mossinery institution, they're doing it because they've got particular financial problems they're trying to address.

SENATOR LESNIAK: You're not regulating the rates because of the rates, you're regulating the rates because of their solvency?

COMMISSIONER MERIN: That's right.

DEPUTY COMMISSIONER JACKSON: Another thing is we're not, as you said, we're not-- You're right. The consumer does benefit from low prices and we want that, but no one benefits when the price is so low that the insurer that sold the product is not there to deliver the service that was purchased. There's another problem. Let's go back to your General Motors and Ford example. If you're General Motors and you've gotten the benefit of dramatic rate reductions that are unrealistic and they adjust the price, well, you said it yourself, General Motors and Ford, they have the economic strength and wherewithal either to say to the companies, "We're not accepting that price. We'll self-

insure. We'll go another route." And they can actually self-insure or they can pay the premium and their product base is so huge that it shows up, the increase, even if it's a 600% increase shows up at some far decimal point removed.

On the other hand, if you're a mom and pop type operation, which comprise 90% of all the businesses in America, and you've got a convenience store on the corner trying to survive against the A&P or the 7-Eleven chain, and sure, you've gotten dramatic price reductions but all of a sudden you're slapped in the face with a 500% price increase, that shows up on your product. It will make you less competitive with the A&P and 7-Eleven and may put you out of business. You can't afford that. I don't think the economy can.

COMMISSIONER MERIN: There are a lot of ways to describe pro-consumer or anti-consumer. I think that you could say that keeping prices up and not letting them go down might be anti-consumer, but on the other hand, bringing some sort of stability to the marketplace and avoiding the wild swings so that after ten years you've paid the same amount as you would have if it had been a more level situation, I think that's pro-consumer. If you look at these things over a long-term as opposed to a given filing or given desire of a particular line by a particular company, it's a lot of gray areas.

SENATOR LESNIAK: What about the group policies? Are group policies allowed to be sold and marketed in New Jersey? Is there any prohibition against them?

COMMISSIONER MERIN: What type of group policies?

SENATOR LESNIAK: Well, if I was XYZ Insurance Company and I wanted to offer to the restaurant association general liability coverage for all their members?

COMMISSIONER MERIN: You can offer it. Most companies aren't interested in that because they're afraid of what they call adverse selection. That's where they offer a group policy, they still want to be able to some extent rate individuals or entities that are a part of that group pursuant to some

experience or some rating characteristics. If they provide a group policy at one rate to every member of the group regardless of characteristics they run the risk of having all the better than average risks seek a better price outside the group and having only those with the high rated, like with the better than average likelihood of producing the incident that they're afraid of be members of the group at this cut rate price.

SENATOR LESNIAK: But there's an impediment in New Jersey for insurance companies offering group policies?

COMMISSIONER MERIN: Not that I'm aware of.

SENATOR LESNIAK: No further questions? Thank you, Commissioner.

COMMISSIONER MERIN: Thank you.

SENATOR LESNIAK: We are now going to move on to-- Jasper, will you be staying with us, or someone from the Department staying with us because we're going to some specific areas that you may-- Or will you get the transcript and read it?

DEPUTY COMMISSIONER JACKSON: I think Dorese (phonetic) is staying.

SENATOR LESNIAK: Dorese, will you please? Thank you very much.

We are now going to go into the area of directors and officers liability insurance and call Joseph F. Johnston from Drinker, Biddle and Reath, I believe, Washington law firm.

J O S E P H F. J O H N S T O N: Right.

SENATOR LESNIAK: Mr. Johnston, what's your view on directors and officers liability and insurance coverage for that? This is it right here, right? This is it?

MR. JOHNSTON: That's it. That's-- I apologize for the length of that. I certainly am not going to go through all of that material right now in answering your question.

SENATOR LESNIAK: Let me thank you for submitting it to us so we'll have an opportunity to submit it for the record.

MR. JOHNSTON: Sure. I've got some factual data in there. I've been in the process of preparing an article on this,

and this excerpts some of that material and puts some other insights that I had into this and you can look at that at your leisure and I'll just to try to--

SENATOR LESNIAK: Wait. I'm sorry. I can't hear. (addressing audience) If you want to talk, please talk outside the room.

MR. JOHNSTON: I'll just try to hit some of the high spots. I was very interested in the discussion that has just taken place with respect to other lines of insurance because there is a certain commonality between what's happened in the D and O insurance market and what has happened in the general liability lines because these are not entirely separate. Many of the same companies write these lines of insurance and the D and O line, which as was described as generally regarded as a surplus line, has been subject to exactly the same types of pressures in this market and has been subject to the same type of cycle that we have seen in certain other lines, particularly in the errors and omissions line.

D and O insurance, I might add in light of the recent discussion, is a claims made policy. It has always been sold as a claims made policy. It has never been anything other than a claims made policy so--

SENATOR LESNIAK: That means in New Jersey it has always been sold as a surplus line.

MR. JOHNSTON: Yes, sir, as far as I know. Now, I'm not the expert on New Jersey but I believe that's correct.

SENATOR LESNIAK: It would have to be.

Is there anything with regard to directors and officers liability that makes it unique from any other type of liability?

MR. JOHNSTON: Well, I don't know that you would say that it's unique, Senator. I think it involves certain features that make it unusual and that make it the subject of a lot of attention recently in view of the fact that a number of corporations have experienced some of their outside directors actually leaving the corporation. There have been some quite

well publicized examples of that, some of which are cited in a footnote in my statement there, of corporations that could not obtain directors and officers liability insurance and have seen their directors just bail out and say they were not willing to risk their personal assets just to stay on the board of that corporation. So we have a serious problem in corporate governance in my opinion, and I think generally shared by the corporate bar, in which corporations, including some good corporations, are having a lot of trouble getting good directors.

SENATOR LESNIAK: What about the Delaware solution?

MR. JOHNSTON: The Delaware solution is one of the ones I speak about in my statement and I think that is an appropriate solution to consider.

SENATOR LESNIAK: Can you describe that to us?

MR. JOHNSTON: Yes. What the Delaware Legislature did was to adopt a statute permitting the stockholders to approve a charter amendment. It would have to be done by a vote of the stockholders and that charter amendment would basically permit the corporation to eliminate or limit the personal liability of directors for breach of fiduciary duty subject to some exceptions set forth in the statute. You could not eliminate their duty for breach of the duty of loyal -- their liability for breach of the duty of loyalty or for dishonesty or for personal profit or willful misconduct, things of that nature. And what this permits corporations to do is to let their stockholders make the choice of how much risk they want to impose on their directors. It seems to me that's a possible solution and perhaps a good one. The other--

SENATOR LESNIAK: Basically they would be limiting their own remedies as well but that's their choice.

MR. JOHNSTON: That's right. They would be limiting their own remedies as well to go after their own directors for negligence.

SENATOR LESNIAK: And if they did that they may be adversely impacting the price of their stock or they may be

improving the price of the stock.

MR. JOHNSTON: That's a good question, Senator. I don't know how the market would react to that, quite frankly. I think the hope is that the insurance market would react favorably and it would then become somewhat easier to get the D and O insurance because the insurance carrier will look at it and he will say, "Well, I'll have less risk than I did before, so therefore I'll write the insurance."

SENATOR LESNIAK: But if I'm buying their stock, and I know that I certainly don't have the voice to change the charter and if a director colluded with management and didn't use their best business judgment in accepting a hostile tender offer that my recourse in that event would be limited by that charter provision.

MR. JOHNSTON: That's correct, Senator. On the other hand, you could make the opposite argument which was that this kind of a provision would encourage people to have directors who were willing to take risks, and after all the economic system that we live under is an economic system where we should encourage directors who will stand up and take risks. And that's maybe what stockholders need. I'm certainly not a market analyst and I can't predict which way markets will go, but my instinct is that this will not be regarded unfavorably in the market.

SENATOR LESNIAK: But in any event what that does is give the share-- We're talking about shareholders remedies, right?

MR. JOHNSTON: Right.

SENATOR LESNIAK: We're not talking about limiting liability for anybody else other than shareholders, isn't that correct?

MR. JOHNSTON: That's right, and the corporation itself.

SENATOR LESNIAK: And the-- To the shareholders?

MR. JOHNSTON: Yes, because--

SENATOR LESNIAK: They wouldn't be-- They wouldn't by-- They aren't authorized by corporate charter under that statute to limit the liability or eliminate the liability of the directors for actions brought by anyone other than a shareholder, former or present shareholders are they?

MR. JOHNSTON: Or the corporation itself.

SENATOR LESNIAK: Or the corporation itself.

MR. JOHNSTON: Yes.

SENATOR LESNIAK: Okay.

MR. JOHNSTON: But anybody else, a creditor or anybody else could bring an action. It also, of course, does not affect any liability they might have under the Federal securities laws, Federal antitrust laws or any other Federal statute. So to that extent it's a somewhat limited remedy.

SENATOR LESNIAK: When did Delaware adopt this?

MR. JOHNSTON: Effective as of July 1, I believe.

SENATOR LESNIAK: Okay. So we really don't know its impact, do we, right now?

MR. JOHNSTON: No, we don't. In fact, there are a number of companies that are in the process of preparing these amendments. I haven't actually seen any that have been finally adopted. So it's going to take a while for this whole thing to work through.

SENATOR LESNIAK: Are there any other proposals? That's the one I'm familiar with.

MR. JOHNSTON: There are. Well, what has happened is the State of Indiana, for example, did what Delaware did only it does not require a stockholder amendment. They just did it in the law. They said no director shall be liable, period, except for these cases of flagrant misconduct.

SENATOR LESNIAK: So they forced it upon the stockholders.

MR. JOHNSTON: They just forced it upon the stockholders.

SENATOR LESNIAK: Kind of like what we did with the

Shareholders Protection Act.

MR. JOHNSTON: Well, I wouldn't comment on that.

SENATOR LESNIAK: I didn't think you would. But basically the remedies that are proposed in your testimony are variations of the Delaware?

MR. JOHNSTON: Yes. I also mentioned in my testimony the New York approach, which is an approach that would broaden the indemnification statute and, for example, would permit a corporation to indemnify its directors for settlements in a derivative action. Now, I have some doubts about that approach. I'm not necessarily saying it's wrong, but it does seem a little unusual in that the money would travel around in a circle in that case. The director would say okay, let's settle this case. He would pay money over to the corporation. The corporation would then turn right around and pay it right back to him by way of indemnity and that strikes me as being sort of a waste of time, at a minimum. Therefore I happen to prefer the Delaware approach which faces up squarely to the question of how much do we want to hold our directors liable for in the first place.

SENATOR LESNIAK: Actually, couldn't you do both? They're really not inconsistent with each other.

MR. JOHNSTON: You could do both, and as I understand it there is a bill that's been drafted, I believe by Pitney, Hardin and Kipp, which would go in both of those directions.

SENATOR LESNIAK: Are they members of the Legislature?

MR. JOHNSTON: No, sir.

SENATOR LESNIAK: I haven't seen them added.

MR. JOHNSTON: They have prepared a draft that's being circulated among the New Jersey corporate lawyers and I don't know where that stands.

SENATOR LESNIAK: Did they circulate it to you?

SENATOR O'CONNOR: Not yet.

SENATOR LESNIAK: Do you have any questions?

SENATOR O'CONNOR: One question. Mr. Johnston, the third approach that you mention, the changing the statutory duty

of care from the reasonable man's standard to a good faith standard -- has that been tried anyplace? Has it been adopted anywhere in any of the states?

MR. JOHNSTON: The State of Virginia did that.

SENATOR O'CONNOR: When did they adopt that?

MR. JOHNSTON: I can't answer that, Senator. I can get back to you on that. It's been within the last year or so I would say.

SENATOR O'CONNOR: Are you familiar with what effect it's had on the industry?

MR. JOHNSTON: I don't know what effect it's had. As far as I know it hasn't had any.

SENATOR O'CONNOR: Okay. Thank you, sir.

MR. JOHNSTON: Yes, sir.

SENATOR LESNIAK: Thank you very much for presenting your testimony.

MR. JOHNSTON: Thank you, Senator.

SENATOR LESNIAK: Following up on that, John Mullen from Johnson and Johnson. Mr. Mullen.

J O H N M U L L E N: Thank you very much, Mr. Chairman, Senator O'Connor. I'm John Mullen. I'm Vice President of Corporate Relations for Johnson and Johnson, the health products manufacturer which for the past 100 years has been headquartered in the City of New Brunswick, New Jersey.

SENATOR LESNIAK: I promise not to ask you any questions about the shareholder protection.

MR. MULLEN: Thank you. My purpose here this morning is to express our appreciation from Johnson and Johnson and on behalf of a number of other companies in the State of New Jersey for your examination into the question of the availability and affordability of directors and officers liability insurance.

We believe, however, that the issue is sometimes too narrowly viewed as one of simply availability and affordability. We believe that the issue really relates to good corporate management. The issue relates to the problem of the

entrepeneurial spirit which is so necessary if you are really going to be in a position to grow companies, to expand and take advantage of the marketplace. We believe, therefore, that as we look at the problem of directors and officers liability insurance we are basically concerned at Johnson and Johnson with the encouragement of our directors and officers to take risks, to exercise sound business judgment without being muted, if you will, by the environment that has been developing in the corporate business world somewhat akin to the problem in medicine where we see doctors practicing defensive medicine. We're beginning to see businessmen practice defensive business.

SENATOR LESNIAK: You favor the Indiana approach over the Delaware approach therefore?

MR. MULLEN: I would say that without any question we would favor the Delaware approach for the reason that we believe that that is a problem, a question, for the stockholders of the corporation to answer. To make that independent judgment as to how they want to manage their enterprise, what standard of conduct they wish to hold their officers and directors to, and furthermore, what kinds of protections they want to afford to those directors and officers.

My purpose here this morning is supplemented by the fact that Johnson and Johnson and approximately 18 other companies in the State of New Jersey and the major business associations of the State of New Jersey have since late June been examining into this question. The previous witness alluded to a draft by a prestigious New Jersey law firm that would examine and make certain recommendations that might be appropriate for the State of New Jersey. We're not in a position this morning to say that that examination has proceeded to the point where we could make specific recommendations. I can say, however, that this committee -- this task force would be a better way to refer to it -- this task force has examined the Indiana statute, has examined the recently enacted Delaware statute, which as the prior witness indicated became effective on July 1st, and has examined some

recent statutory amendments in the State of New York as well as some proposals that have been made by Martin Mugmen (phonetic) in New York to cap director and officer liability. So this task force is really examining several approaches to the problem. The task force, as I've indicated, has been meeting since late June, and met as recently as ten days ago. It will be meeting again in September. At the conclusion of our September meeting we feel that we'd be in a position to sit down with your Committee or with any other appropriate committee in the Senate or in the Assembly to review what the feelings would be with regard to this segment of the New Jersey business community as to how New Jersey might best approach the problem of directors and officers liability insurance.

We believe that there's a competitive situation here as well. We are not anxious to see the State of Delaware become a more competitive and more attractive environment for incorporation than the State of New Jersey. Similarly, I think the press has reported that the State of Pennsylvania is examining a similar statute to that enacted by the Delaware Legislature which became effective on July 1st and which would allow the shareholders of the corporation to impose some limitations on director liabilities to the corporation and to those shareholders.

So my point today then, in summary, is to encourage the interest of your Committee into the problem of directors and officer liability insurance, and to afford this rather informal task force which is not, of course, a part of your legislative constituency, but to allow us to come back to you with certain recommendations after this committee has fully examined the problem. And I think we're encouraged by the breadth of the membership on our committee. As I said, the major business associations of the State of New Jersey are participating in this examination. The major well known New Jersey incorporated businesses are participating. Small business association are participating. So it's a problem that is of concern not only to

the major Fortune 500 companies, but it is a problem as well that affects our banks and they're part of a -- a number of the New Jersey banks are a part of our task force. It affects banks and small business as well.

SENATOR LESNIAK: When is the task force meeting again?

MR. MULLEN: The task force will be meeting again on September 19th and at that time, I believe, we will have reached a final determination as to what an appropriate statutory recommendation might be as far as these companies are concerned. It certainly doesn't speak for all of New Jersey, but as far as these companies and business associations are concerned.

SENATOR LESNIAK: I would suggest that you not adjourn that meeting because we intend to act in September on -- at least consider in September a proposal in this area. Thank you very much.

MR. MULLEN: Thank you very much.

SENATOR LESNIAK: Before we adjourn for a brief moment we're going to hear from Hector Mendez from Continental Insurance Company to rebut the testimony of the Commissioner as it applies to the claims made form. Unfortunately, Hector, the tone of my voice isn't taken down by the transcript, so I don't really expect you to rebut the testimony but I did specifically ask that if you would appear here today with regard to your proposed claims made form as it applies to day care centers, which is a particular problem in my district. You heard the testimony of the Commissioner in that regard. Would you describe his testimony as accurate factually?

H E C T O R M E N D E Z: Somewhat accurate. I tend to disagree with his approach towards the admitted company and the surplus lines company, the differences and why they should permit a domestic company to write the coverage in New Jersey on a claims made basis. What I'd like to do is just briefly give you a description of our program, why it is a claims made form, and why we think claims made form works for day care insurance.

SENATOR LESNIAK: Okay.

MR. MENDEZ: Back in the fall of 1985 Continental was approached by Marsh McClennan Group Associates (phonetic) and the Child Care Action Campaign to work with them to develop a program for liability coverage for day care centers. At that time, and I guess currently, day care centers are experiencing a severe crunch in the liability market and find it very difficult and expensive to obtain coverage. Continental responded to that problem with the introduction of the day care provider liability policy. The policy provides general liability coverage on a claims made basis to licensed or registered day care providers. The coverage includes general liability insurance, including premises and incidental off-premises operations coverage for claims bodily injury, property damage, personal injury and advertising injury arising from day care liability, day care provider liability at or away from the premises. It also includes medical payments and defense expense. The day care facility and employees are both covered for civil suits arising out of the insureds' negligence. We don't cover intentional or criminal acts, but we do cover hiring -- negligent hiring and negligent supervision. Which I think gets back to the point that the Commission concerning molestation cases. We don't cover the criminal act, but if the insured or the attorney can prove that the day care facility was negligent in its hiring or in its supervision of employees we will cover that exposure.

SENATOR LESNIAK: Does that mean that there's a misunderstanding between the Department and your company with regard to exactly what coverage you're seeking to provide?

MR. MENDEZ: I'm not certain there's a misunderstanding, but I think our coverage is a little more broad than the Department construes it to be. If the only allegation in the complaint is a criminal act or a molestation, our policy specifically excludes that kind of coverage. But if an aggressive attorney can prove that the day care center was negligent in the supervision of its employees or its hiring practices, and that resulted in molestation in the future, I

think we might provide coverage in that instance.

SENATOR LESNIAK: But the Commissioner said there have been 16 applications to the MAP program for day care coverage and they've all been able to get coverage, and Continental is part of the MAP program. Are you providing some of that coverage to those 16?

MR. MENDEZ: I'm not sure.

SENATOR LESNIAK: You don't know. But I guess what he's saying is it's really not a problem any more. Does that comport with your knowledge of the status in New Jersey?

MR. MENDEZ: My understanding of our problems in New Jersey were related to-- Our original policy provided that defense was included within the policy and the State was not very happy with that position and, for your information, we backed off from that approach and at present we're refiling the form in all 50 states to provide defense in addition to the policy limits. I'm not aware of any other problem with the State of New Jersey.

SENATOR LESNIAK: No, no. From what I can gather from what the Commissioner said there really is no longer a problem in terms of day care centers getting insurance coverage because all they have to do is go to the MAP program and so far everyone, 16 out of 16, have gotten it.

MR. MENDEZ: Well, I believe there still is a problem in the State. I don't believe the MAP programs are set up to write day care insurance for everybody in the State. I think they're intended to write it for isolated cases where they're having real difficulty in getting coverage and they demonstrate a real need for the coverage. I think it is a short-term solution and the program we're proposing is a long-term solution to the problem.

SENATOR LESNIAK: Okay. Is it out of the question that the Department and you can continue discussions regarding this, Vernice? I mean, am I correct in saying there's no problem any more for day care coverage in the State of New Jersey?

V E R N I C E M A S O N: Not exactly. All I'm saying is that

with regard to the applications that have been made to MAP program, they have all been placed other than the three that were most recently made. If there are--

SENATOR LESNIAK: Oh, I'm sorry. I thought you said that 13 out of 16 were place and then I thought you said the three most recent ones just got--

MR. MASON: They just received the-- The MAP just received those applications.

SENATOR LESNIAK: Oh, okay. So they haven't gotten the coverage yet, but they really haven't gone through the process yet.

MR. MASON: Exactly.

SENATOR LESNIAK: So 13 out of 16 and three are still pending.

MR. MASON: Right. My point is that if there is a continuing problem -- I'm not sure whether there is or is not -- those also have the opportunity to go to the MAP and it has been very successful thus far. We have been working with a task force that DYFS has set up with regard to day care centers and they have been sending out alerts and they have been putting people through the MAP program. One thing that we have found is that the more that you encourage agents and brokers to sit down and spend more time with their clients and try to place them, they seem to be having a greater impact in placing them. I don't know why that is. And also the MAP is putting together individual companies who are willing to write the coverage for people who need the coverage.

SENATOR LESNIAK: Now, the MAP is only for--

MR. MASON: Day care centers.

SENATOR LESNIAK: Admitted insurers, right? You're not placing them with surplus lines?

MR. MASON: That's correct. We're placing them with admitted insurers.

SENATOR LESNIAK: Well, as it stands right now, until we-- I intend to find if -- how my day care center in Elizabeth,

whether they've obtained coverage.

MR. MASON: Maybe they should make an application to the MAP.

SENATOR LESNIAK: Well, I suggested that they did. Have they not done that?

MR. MASON: To be honest with you I wasn't aware of a problem in your district. Very happy to make that contact for you.

SENATOR LESNIAK: Okay. I suggested that they did get in touch with you. I don't know. I assure you we will continue to pursue this to see if, in fact, if there's no problem, there's no problem. I tend to think that there probably is.

MR. MENDEZ: My understanding with the MAP program and I think the understanding of many of the companies who are participating in the MAP program is it is only a short-term solution, and they don't expect to participate in those programs on an on-going basis forever. I think if a company is willing to go out and write the product voluntarily on what they believe is a reasonable basis that makes a lot more sense than a MAP program.

SENATOR LESNIAK: Can we ask the Department to at least clarify whether if in fact-- Jasper said that it doesn't cover any child abuse. Mr. Mendez is saying, no, that's not correct. It would cover child abuse in the situation where you could prove the day care center was negligent in hiring the person who engaged--

MR. MENDEZ: Hiring or supervision.

SENATOR LESNIAK: Or supervision of the person. It appears to me like they may agree but don't know it.

MR. MASON: Senator, I really can't tell you. I'm not intimately involved with that project, but I am aware that there has been a long history of correspondence between the Department and Continental Insurance Company with regard to this application. When we have questions in the filing that is made we ask (inaudible)-- to get information in writing regard to the

response. So if this is, in fact, a point of controversy I will make that known to the Commissioner and try and get this resolved.

SENATOR LESNIAK: One other thing. The MAP program isn't intended to exist forever, is that correct?

MR. MASON: I don't know. I don't think so.

SENATOR LESNIAK: Hopefully not, right?

MR. MASON: Yes, I would think that it's a short-term mechanism to try to deal with the availability problems that have been going on in the market.

SENATOR LESNIAK: Okay, so we ought to be looking at longer term solutions, of which this is one of many, and maybe after we do whatever we're going to do, if we do it you may have to revisit this particular application. Do you think that's a fair comment?

MR. MASON: That may be (inaudible).

SENATOR LESNIAK: You say that may be a fair comment? Okay.

As you've had a ongoing discussion with the Department on this, we will continue the ongoing discussion and consider what you've proposed in terms of whatever this Committee can do or this Legislature can do to help solve the problem.

Can you submit-- Do you have prepared--

MR. MENDEZ: Really scribbled notes.

SENATOR LESNIAK: Okay. But I think we have-- Unless you have any?

SENATOR O'CONNOR: I have a question.

SENATOR LESNIAK: Senator O'Connor.

SENATOR O'CONNOR: Mr. Mendez, I heard the Commissioner say that per occurrence insurance is definitely preferable to the claims made form, so that the way he views it he would only approve the claims form in very limited lines of insurance. Do you disagree with that?

MR. MENDEZ: I do, and I guess I have a few reasons for it. In connection with day care centers, especially, the claims

made form is intended-- Day care centers the real problem is slips and fall type cases which is shorttail coverage. I think the claims made form response to that at a much lower cost than the occurrence form-- We don't need to add a premium load into the policy for occurrence type coverage for late claims that come into the distance future for an injury, any latent injury that may have occurred while a child was in attendance at a day care center.

More importantly, I think, the day care center has the ability to adjust its limits on an ongoing basis with the claims made form for late developing claims, which I believe is very important. Under an occurrence form you don't have that option. Claim occurred five years ago, the limits which were in effect five years ago are those that will be around to pay the claim. With the claims made form on an ongoing basis as the tort law develops, case law develops, the companies combine more and more coverage, and I think can buy it a lot cheaper. During the period of time when they had the claims made form and the lower limits I think the premium we would have put into the policy was retained in the insured's bank account for future policy years to pay the premiums then, rather than the company holding the money and using that money as a reserve to pay for those future losses. So I think there's a lot to be said for the claims made form.

SENATOR LESNIAK: That's an interesting point. So there are certain benefits of the claims made form over the occurrence related to both price and flexibility.

MR. MENDEZ: Yes. I think we can adjust the price a lot quicker with a claims made form because generally the statistics are more credible. There's a short time lag between the time the policy period ends and the claims reported. We know what's happened under the policy. We can give the insured the benefit of a lower rate. If his experience is very poor, obviously we're going to increase the premium.

SENATOR LESNIAK: Okay. Any other questions?

SENATOR CARDINALE: Under that kind of insurance, what

assurance is there that your insureds can obtain coverage for subsequent claims that may be made for a prior policy, a prior period of time?

MR. MENDEZ: Well, the policy offers a retroactive date feature where the insureds can purchase as part of the policy coverage for claims occurring prior to the policy period so long as the claim is made during the policy period.

SENATOR CARDINALE: Yes, that's perspective. That is if someone is willing a year from now or two years from now or five years down the road to pick up those back potential claims. But suppose someone is not writing that business five years down the road. The insured who would take that kind of thing, where you have a statute of limitations that goes well beyond the cancellation of the policy or the termination of the policy, that insured is really at some enormous degree of risk. They may as well go bare from the beginning.

MR. MENDEZ: I'm not sure I agree with that. The policy does offer an extended reporting period in the event the company fails to renew or cancels the policy in accordance with New Jersey law. The insured has the option to buy an extended reporting period of up to five years even though we no longer have a policy period in effect. If he reports the claim within that period of time he still has coverage for those claims that occurred earlier.

SENATOR CARDINALE: If they accept it, these extended periods, would there be any saving in premium by buying the two policies now to cover, let's say the year 1979. Supposing you had a policy in effect for the year 1979 and you came to 1980 and now you're discontinuing doing business with that company, but you're going to take the five-year hence policy. Would the sum of those two premiums be a saving for the individual?

MR. MENDEZ: I'm not certain. I can't answer the question.

SENATOR CARDINALE: Unless there is a savings, then it is not anything but dividing it into two pieces, and it would

seem to me that the writing of two separate policies is going to involve a greater cost, not a lessor cost, in terms of administration and everything else. So I really see that for the same insurance feature, buying that same product, you're going to have the consumer paying more money rather than less money. It's the only way it can--

SENATOR LESNIAK: It really boils down to what the marketplace-- If there's no problem in getting the insurance, if there's not a capacity problem or capacity crisis, there should be no problem with the claims made form. As a matter of fact, obviously, by definition there's less because of its more predictability to the insurer. The problem in terms of the consumer is what happens when you do hit a crisis, everybody bails out, then they're stuck.

SENATOR CARDINALE: That's right.

SENATOR LESNIAK: But they're bailing out now anyway, so--

MR. MENDEZ: I think you have-- Continental is a licensed company in the State of New Jersey and from my understanding it is one of the only companies that proposes to write this kind of insurance in New Jersey on this basis. The only other companies writing it are surplus lines companies that are not regulated by the Insurance Department.

SENATOR LESNIAK: It may be with regard to the long run that this is a viable solution. I would just encourage you to continue your discussions with the Department. Thank you very much.

MR. MENDEZ: Thank you.

SENATOR LESNIAK: We're going to adjourn the public hearing now. That means going off the record for the public hearing.

RECESS

AFTER RECESS

SENATOR LESNIAK: Let's reopen the Committee hearing to deal with the issue of capacity to write insurance in the State of New Jersey. I might say again that this will be continuing process and we'll be continuing to explore different avenues as was demonstrated with the claims made form for particular lines of discussion with Continental and the Department. I expect that all these issues will continue to be -- remain viable throughout the next few years at least.

Jay Angoff, Counsel to the National Insurance Consumer Organization. Good afternoon, Jay.

J A Y A N G O F F: Good afternoon, Mr. Chairman.

SENATOR LESNIAK: Do you have prepared testimony?

MR. ANGOFF: I have a prepared statement which I just gave to Mr. Davis. I won't go through everything we've got in there, all the solutions to the insurance crisis. What I'd like to deal with is just the disclosure issue. I think disclosure data is something that probably more than 40 states are looking at this year. It's probably second only to tort reform as far as the number of states looking into it are concerned. I think it's very important because you, Mr. Chairman, of course, understand terms like losses incurred but not reported, and operating ratio and loss ratio, and surplus lines and excess lines. But the average person doesn't understand any of that. It's an archaic industry. It's got its own vocabulary and I think it's very important that the industry does disclose data on issues which it today does not disclose.

I think there are four areas in which disclosure is very important in four areas which are not disclosed today. The first is profitability, is not the way the insurance industry defines it, that is not based on the amount that they predict that they're going to pay out in the future, but on a cash flow basis line by line. That is what the average person and legislators want to know and what they just can't find today: how much does the industry take in in premiums and pay out in claims for each type of insurance; for day care insurance, for municipal

liability, for nurse midwives. That type of information today is not disclosed and I think I heard earlier the Commissioner say he does have that power. If he doesn't, though, under present law I think this Committee should certainly consider requiring the disclosure of that data. I think that type of requirement is in bills either 2318 or 2319.

In addition, though, to that type of data, there is a second type of disclosure which is also important and that is data on the validity of statistics or anecdotes that we hear a lot about. For example, on the issue of jury verdicts, I'm sure you've read in the papers, heard on TV about how jury verdicts are skyrocketing. And people might--

SENATOR LESNIAK: The insurance industry doesn't have anything to do with jury verdicts. They don't report jury verdicts.

MR. ANGOFF: No, they don't report jury verdicts, but services that they rely on, report jury verdicts. But the point is this, there's huge difference between jury verdicts which we hear about and the actual amount paid out which we don't hear about. The information I've got just from Washington, D. C. shows that the actual payout is usually about half of the verdict. Sometimes it can be substantially less. For example, there's the Ford Pinto verdict which was $125 million punitive damage verdict.

SENATOR LESNIAK: Would you therefore bar sealed -- bar either sealed settlements or restrict the disclosure agreements, whatever they're called, when they settle the case that neither party can disclose the amount of the settlement?

MR. ANGOFF: We're opposed to such agreements. We think they're against public policy.

SENATOR LESNIAK: But they're allowed in New Jersey.

MR. ANGOFF: I understand that. I understand that, but I think that as a matter of public policy it's bad. It puts the plaintiff's lawyer especially, in a terrible position. On the one hand he gets a good settlement for his client--

SENATOR LESNIAK: On the other hand, he can't brag about it.

MR. ANGOFF: That's exactly right. And there's nothing plaintiff's lawyers like more than to brag about it. But in addition it does -- this may not be the primary concern of some of the plaintiff's lawyers -- but it does not--

SENATOR LESNIAK: Been a concern of mine on occasion.

MR. ANGOFF: It does not further the public interest to have information sealed, especially when that information shows that there is a defect in the product, product stays on the market and injures and kills many more people. So I--

SENATOR LESNIAK: That's products liability.

MR. ANGOFF: That's right.

SENATOR LESNIAK: Does that apply to any other case?

MR. ANGOFF: Certainly medical malpractice it certainly would. It may even be a bigger problem in medical malpractice.

SENATOR LESNIAK: Medical malpractice, products liability. Do you think it's important anywhere else?

MR. ANGOFF: Not as important. I think those are the two big areas where sealed settlements really are against public policy. I think there are a lot of different -- there are different considerations that would apply, for example, in municipal liability cases than in products and medical malpractice. In any event, I think it's very important that the Committee find out, the Legislature find out how much is actually paid out in addition to how much the verdict is.

There's a third type of disclosure which is very important--

SENATOR LESNIAK: By the way, on that line of thinking, it's important for the Department to know that, is that correct?

MR. ANGOFF: I'm sorry?

SENATOR LESNIAK: You say that's important that the Department of Insurance know that.

MR. ANGOFF: It's important for the Department of Insurance to know how much is actually paid out, that's true.

SENATOR LESNIAK: Okay. Is it important for anyone else to know that?

MR. ANGOFF: Yes. It is very important for you, Mr. Chairman, and other legislators to know how much is actually paid out because this year most legislatures have been considering reducing the amount that severely injured people can recover in court. The basis for that is a belief that insurance companies are paying out more and more. And if that belief turns out to be false then there goes, I think, the case for limiting the amounts severely injured people can recover. It's substantially undercut, so I would hope that before you would enact legislation that would limit the amount that severely injured people could recover you would make sure that the actual amount being paid out has been and is rising, particularly in New Jersey.

SENATOR LESNIAK: What if we do this and determine two years down the road that that, in fact, is the case. What would we do then?

MR. ANGOFF: If you determine two years down the road that the insurance companies--

SENATOR LESNIAK: That the insurance companies are right.

MR. ANGOFF: Okay. Then two years down the road-- Well, you've got a-- Obviously you would also want to consider setting up an alternative compensation system for the people who would thereby be left without recovery with insufficient recovery. But then two years down the road maybe you would want to enact some type of limitation. But it's important to get that data.

Maybe the insurance companies are right. I, obviously, have my doubts, but I think--

SENATOR LESNIAK: You don't know if they are or they're not.

MR. ANGOFF: That's right, and no one really does until you get the data, and that's why it's so important.

The third type of data is data on the effect that

existing legal doctrines are having on insurance company payouts and then also the effect that changing those doctrines would have on payouts. For example, there's been a lot of discussion, even here in New Jersey, on at least modifying the rule of joint and several liability. And I would hope before you would do that you would find out how often are defendants involved in multiple defendant suits and how often do they actually end up paying more than their share of responsibility as allocated by the jury? And to what extent to they pay more than their allocated share? You also want to find what the breaking point is.

For example, you might find that people that are 10% liable -- defendants who are 10% liable -- never end up paying more than-- Well, if you found out that people who were 10% liable ended up paying 100%, that's a much different situation than people who are 50% liable ending up paying 100%. I might say in Illinois they found that the way they drew the line was at 25%. They said that defendants who were less than 25% liable are only severally liable. People who are more than 25% liable are jointly liable.

Now I don't know what the data would show, but again, I think before altering a doctrine like joint and several liability you would want to find out exactly how much savings it would mean to the insurance industry and similarly what the effect-- I think you would also want to find out what the effect on the victim would be. And again, possibly consider setting up an alternative compensation system for victims who would thereby be undercompensated.

Or let's take another change in the legal system that's being discussed: putting limitations on damages for pain and suffering. You want to find out whether people who have had particular injuries are overcompensated or undercompensated. The best study done in this area was done by the Department of Transportation in the early 1970s on no-fault auto insurance, and what they found, which might be a little counterintuitive, was that people who were very moderately injured were way

overcompensated, and people who were very seriously injured were substantially undercompensated.

SENATOR LESNIAK: That was very similar to the situation we had in New Jersey regarding workers' compensation.

MR. ANGOFF: All right. I'm unfamiliar with that situation.

SENATOR LESNIAK: We changed that law around 1980 if I recall, and now the situation is that where there has been a substantial increase in those people who are most seriously injured, at the same time a substantial reduction in the cost of insurance to the businesses.

MR. ANGOFF: There's been a reduction in the cost of insurance?

SENATOR LESNIAK: At the same time there's been a substantial reduction. At the same time there's been a substantial increase in the amount that more seriously injured persons get. Of course, there's also been a substantial decrease in the smaller awards, the $500 to $1500, $2000 awards that were just issuable in the past. So that may be the same situation as our civil justice system. I don't know.

MR. ANGOFF: Well, it's quite conceivable. I've heard the argument made, and I think there's quite a bit to it, that the real problem in the legal system is not the big cases. When you read about big jury verdicts they are for serious, very serious injuries and the problem in the legal system is the-- Maybe we should call it a problem, but what clogs up the legal system is the little cases, the slip and fall cases, is the run of the mill negligence cases and conceivably if there were an alternative dispute resolution system to take care of them that would make the legal system quite a bit more efficient. But in any event, you want to get the data, I would think, before limiting the ability of somebody who is a quadriplegic or a double amputee to recover his or her full damages.

The fourth type of data I think you need is somewhat similar to that--

SENATOR LESNIAK: Did you say fourth?

MR. ANGOFF: Yes.

SENATOR LESNIAK: What happened to three? Did I miss it?

MR. ANGOFF: The first was cash flow data.

SENATOR LESNIAK: Right.

MR. ANGOFF: Second is on the validity of various perceptions, data on--

SENATOR LESNIAK: Okay, the jury verdict.

MR. ANGOFF: And the third was data on the effect of changes in the tort system.

SENATOR LESNIAK: Tort reform, okay.

MR. ANGOFF: And the fourth is the effect that other types of changes in the tort system, but these are not changes which the insurance industry, for example, is supporting publically, anyway. They're not changes that would limit the ability of severely injured people to recover. They are changes which I think would make the legal system more efficient. For example, the fastest growing-- We hear a lot of talk about plaintiff's lawyer's fees that are out of control, although I should mention that in New Jersey based on a survey that we've done, plaintiff's lawyer's fees are limited more than anyplace else in the country. The sliding scale in New Jersey is the least generous in the country. But what we don't hear too much about is the increase in defense lawyer's fees. But if you read the trade press of insurance companies, what they say among themselves-- You find that defense fees have gone up three times as fast as the amount actually paid to victims in the last 25 years. That by 1990 the money they pay to their own lawyers -- not including the plaintiff's lawyer -- their own lawyers will be 50% of the actual amount paid out and this is easy to understand when you-- There's an article in The Washington Post just--

SENATOR LESNIAK: Fifty percent of what?

MR. ANGOFF: I'm sorry. Fifty percent of the payout goes for lawyers, that is 50% goes to the lawyer, 50% goes to

victims.

SENATOR O'CONNOR: You said defense lawyers?

MR. ANGOFF: Defense lawyers, that's right.

SENATOR LESNIAK: Fifty percent of their total payout?

MR. ANGOFF: Yes. That is the estimate by 1990. And that does not-- That's right. And the ISO, in fact, put out a booklet in which it says we've got to do something to get these defense lawyers' fees down. I think if you talk to any insurer privately he'll tell you that that's a very big problem. In any event, I think it's important to get data in New Jersey on not just the percentage that goes for legal fees, but the percentage that's spent on legal fees in different types of cases with different types of outcomes. For example, it may turn out that for cases that take a long time where the plaintiff ends up getting a fairly small settlement, the defense fees are huge, much more than the amount the plaintiff gets, and it might make more sense to go to a different system where there be an early settlement process the plaintiff would be more, the defense lawyer would get less.

SENATOR LESNIAK: Are you saying that insurance company management does not act like rationale human beings?

MR. ANGOFF: It's been said before, Mr. Chairman.

SENATOR LESNIAK: Trying to-- I didn't say whether it's been said before. I'm asking if you say it. Don't they have an inducement to curtail these costs and keep them down? I mean, you don't think there collusion between the defense bar and the insurance companies, do you? Or do you?

MR. ANGOFF: Well, according--

SENATOR LESNIAK: We have some defense lawyers in the group. I'm sure they would want me to ask that question.

MR. ANGOFF: I think it would be very interesting to hear what they've got to say, but I do think that sometimes the interest of the defense lawyer is not congruent with that of the defendant and that it may be -- and I would think some defense lawyers would try this anyway -- it may be to the defense

lawyers' advantage to draw out cases, to delay, to file motions and objections even though they know that they will not be upheld in the end because their meter keeps running. And it might make more sense for the defendant to settle quickly for a little higher sum and pay less to the lawyer. I don't know, but I think we need this.

SENATOR LESNIAK: What's the general practice? Isn't the general practice that the insurer controls the defense lawyer, even though actually the insurer shouldn't because the defense lawyer is supposed to be representing the insured, not the insurer. But doesn't the insurer call the shots when authorizing depositions, authorizing settlement? I know the practice probably varies, but isn't that generally the case?

MR. ANGOFF: I think it varies particularly by size of company, but I think that it shows that we really do have very little data on this issue and I think it's an area that should be explored and an area in which by saving -- by cutting down on lawyer's fees we might be able to both get more money to the victim and have the defendant pay out less. Everybody gains except for the lawyers, which is a popular thing to say these days. But in any event that's a different type of approach to bringing costs of the tort system down than limiting the amount that severely injured people can recover.

Another type within this same fourth category I think you would also want to find out how long it takes to try certain cases. How long a time is there between injury and complaint, or complaint and verdict, or verdict and actual payment? And again, if you find out that the length of time is years and years, maybe there is something that can be done to bring down that time.

SENATOR LESNIAK: Well, in New Jersey it's about three years.

MR. ANGOFF: Between complaint and--

SENATOR LESNIAK: Between time the you file the complaint and if you try the case, when the verdict comes in.

MR. ANGOFF: That's--

SENATOR LESNIAK: Pretty good I guess.

MR. ANGOFF: In Los Angeles it's five years and I know in some southern states it's quite a bit less, but I think these are where the costs of the legal system really are beginning to be uncontrolled and where they should be controlled and where there can be savings to everyone also.

SENATOR LESNIAK: And also we have interest running from the date the complaints filed as well.

MR. ANGOFF: Okay, and I know there's a controversy about what the incentives are with respect to that.

SENATOR LESNIAK: Well, I mean, don't you think that's good?

MR. ANGOFF: Yes, I do. Yes. I absolutely do. There are a number of states which have done -- taken various approaches to data collection. One state which is doing what we regard as a very positive investigation is Texas. I've enclosed as part of my testimony the questionnaire that Texas has sent out to its insurers. It's doing a closed claim study and it is finding out exactly how much is paid for economic damages, how much for past economic damages, how much for future, how much for pain and suffering, joint and several liability questions, and this study should be done within, before the Legislature goes into session next year. It will give the Legislature there a basis on which to determine what, if any, changes it should make to the tort system.

SENATOR LESNIAK: You would recommend that we direct the Department to conduct closed claims studies?

MR. ANGOFF: That's correct. To get the data on how the tort system today is affecting insurance company payouts and how the most frequently suggested changes in the tort system are likely to affect future payouts. I think that's very important. There's also language on pages four to eight of the paper I submitted which asks for the same thing as the Texas closed claim study did. Also the Department of Transportation's no-fault study done in 1970, is about 21 volumes. They did the best job in

this area of finding out really exactly who gets hurt and what type of injuries are compensated to what extent. And it's really a very-- It's the best thing that's been done; it's a very good model.

SENATOR LESNIAK: That was 1970 though.

MR. ANGOFF: Yes, that's right.

SENATOR LESNIAK: It's been 16 years since then.

MR. ANGOFF: It certainly has. It's time for another study, I think, that is as exhaustive, but in a broader, I think in the, particularly, the products liability area.

I'd like to close with three points. The first is there's a problem not just in the type of data that's collected or not collected, but in making this data accessible to the public. Today some data is disclosed, but it's buried in the files in Trenton and the public just doesn't know about it. And it's not in English. I think if there were a way to make the data more accessible to the public -- for example, for the Department to put out press releases every six months or every year or so on the amount that insurance companies take in, took in 1985 in New Jersey and paid out for day care center insurance or municipal liability insurance, I think that type of figure would be helpful.

The second point is this, that these changes in the law that are being considered like altering joint and several liability or limiting damages for pain and suffering obviously do hurt people and the Legislature certainly has as a legitimate function-- I mean it's a legitimate function for a Legislature to decide that as a matter of public policy that makes sense. But I would hope that you would get something for it. And that's why it is so essential to get the data.

The final thing is just to emphasize what a tough job it is to get the data. I'd like to read something from a Congressional Small Business Committee Hearing in 1978 when the Committee asked exactly the questions that I think this Committee should ask of the insurance committee -- of the insurance

industry. For example, the Small Business Committee asked, "Please construct a table listing for each of the last seven years the number of product liability claims you have paid in each of the following amount categories: over a million, between 500 and a million, between 100 and 500,000, between 50 and 100,000, between 10 and 50, under 10." A very straightforward question. It's exactly the kind of data we need to know what insurance company payouts are and who is getting how much. Here are the answers of the insurance industry. "Aetna Life and Casualty: This type of information is not maintained and therefore not available. American International Group: We do not maintain statistical records in sufficient detail to provide a size of loss distribution on closed products liability cases. Crum and Foster: We do not have available any breakdown of our product liability claims in the detail requested. Firemen's Fund: Firemen's Fund does not maintain the claim data on the basis requested."

Now this is the response that they gave to the Small Business Committee eight years ago and it's the response they've been giving for the past eight years to everyone. And I hope that this Committee can somehow do what no one has been able to do before, which is to get the answer to the questions that the Small Business Committee asked in 1978 and have yet to be answered.

SENATOR LESNIAK: Are any other states getting those answers?

MR. ANGOFF: Generally no. Occasionally one company will come in with partial information, but generally no.

SENATOR LESNIAK: You say Texas though is getting--

MR. ANGOFF: That's what they're asking for, yes. And I'm not familiar with exactly how they're doing, but Texas is asking for absolutely the right information. It's just now a question as to whether they get it.

SENATOR LESNIAK: Senator Cardinale?

SENATOR CARDINALE: I'd like to ask him a few--

SENATOR LESNIAK: I knew you would, Senator.

SENATOR CARDINALE: I see that there's a title on this, National Insurance Consumer Organization. When was that formed?

MR. ANGOFF: 1980.

SENATOR CARDINALE: 1980?

MR. ANGOFF: Yes.

SENATOR CARDINALE: How has it been funded since that time?

MR. ANGOFF: It's been funded by dues from our members. We've got a couple of thousand members who each pay $25 a year and also by selling publications such as little pamphlets, "How to Save Money on Your Life Insurance, How to Save Money on Your Health Insurance." We've also gotten quite a few, for us, sizable grants from foundations.

SENATOR LESNIAK: Does that include the Ralph Nader Foundation?

MR. ANGOFF: There is no--

SENATOR LESNIAK: The proceeds from the Pinto suit?

MR. ANGOFF: No. We're not affiliated with Ralph Nader. We got a big grant recent from a foundation called the Stern Foundation, which is run by Phil Stern who happens to be the heir to the Allstate -- the heir to the Sears fortune who ironically owns the Allstate Insurance Company. But that's where -- that's our biggest grant. We get some money from the Rockerfeller Foundation.

SENATOR LESNIAK: See, they're not all that bad.

MR. ANGOFF: I'm sorry?

SENATOR LESNIAK: They're not all that bad.

MR. ANGOFF: No, Allstate does some good things, but it's somewhat-- (Laughter) It's somewhat ironic.

SENATOR CARDINALE: What's your annual budget?

MR. ANGOFF: In '85 our annual budget was just over $100,000. This year it will be somewhat more, but I would think certainly between 100 and 200.

SENATOR CARDINALE: Now you say you have a couple of

thousand members.

MR. ANGOFF: Correct.

SENATOR CARDINALE: For an organization with a couple of thousand members you seem to be making an awful lot of trips around the country. This was presented in Virginia and so forth and so on. Do you have a particular kind of purpose to your organization? Was it formed for a specific purpose in 1980?

MR. ANGOFF: Yes. Yes, and perhaps I should have started with that. The National Insurance Consumer Organization is a nonprofit, nonpartisian consumer group that monitors the insurance industry and seeks to inform the public about insurance industry practices.

SENATOR CARDINALE: Of you-- You say you have a couple of thousand members?

MR. ANGOFF: Correct.

SENATOR CARDINALE: Of your couple of thousand members are they from all walks of life? I mean do you have a number of dentists in your organizations roughly the same as the number of dentists out in the general population and the number of steam fitters, the same number of people, and so forth? Are you--

SENATOR LESNIAK: Senator Cardinale, why don't you ask him questions about his testimony? I mean--

SENATOR CARDINALE: I will, but the first part of his testimony is that--

SENATOR LESNIAK: Did you find any problems with his testimony?

SENATOR CARDINALE: --he's the National Insurance Consumer Organization. I want to know what that means.

MR. ANGOFF: Fine. I'd be glad to answer all those questions. No, we haven't done a survey of whether, for example, the percentage of dentist among our members is equal to the percentage of the dentists in the public at large.

SENATOR LESNIAK: You haven't done a closed claims survey of your own membership.

MR. ANGOFF: No. We have got no reason to suspect that

any group is particularly over or under represented with the possible exception that the insurance industry probably would not be -- insurance industry officials probably would not be members, although we probably do have a couple.

SENATOR CARDINALE: I see. So you're just a general run of the mill organization. You just have the same background as every other consumer group.

MR. ANGOFF: Well, I don't know how to take the phrase run of the mill. We think that the difference between us and other consumer groups is that it was founded by a guy named Bob Hunter who was Federal Insurance Administrator under President Ford and President Carter, and is an actuary and does have substantial expertise in the insurance industry and I think we're the only group that-- The insurance industry, as I said earlier, is a very difficult industry to understand. It's got its own language. As Andrew Tobias said in his book on the insurance industry, "It's not boring, they only want you to think it's boring." But in any event the insurance industry has traditionally not been studied by consumer groups. I think we are the only one that devotes full-time to studying the insurance industry. And the reason is because Bob Hunter was in the industry, or in government for 30 years and when he left the government he wanted to-- This is what he decided to do.

SENATOR CARDINALE: I think, you know, just one more question along this line. I think that there is some kind of national statistics -- correct me if I'm wrong -- that about 2/10ths of 1% of the people in the United States are attorneys, is that correct?

MR. ANGOFF: I don't know.

SENATOR CARDINALE: Are more than 2/10ths of 1% of the people in your organization be attorneys?

MR. ANGOFF: Probably not, and if they are it would be fairly insubstantially more than that.

SENATOR CARDINALE: So less than 1% of your members are attorneys?

MR. ANGOFF: I've never done a survey, but I can say this with pretty good certainty--

SENATOR CARDINALE: That perhaps explains something, because I really I thought your organization was composed mostly of attorneys. However, however, now you've explained that it isn't, you seem in your testimony to have talked about too much of the insurance dollar being spent on legal fees.

MR. ANGOFF: Correct.

SENATOR CARDINALE: And you said that by 1990 50% would be spent on defendant's lawyers.

MR. ANGOFF: Correct.

SENATOR CARDINALE: And of the other 50% a portion is being spent on the plaintiff's lawyers, is that correct?

MR. ANGOFF: Correct.

SENATOR CARDINALE: You seem to take the position that that's inappropriate for so much of this insurance dollar to be going to attorneys' fees.

MR. ANGOFF: It's inefficient. I mean, it's for the Legislature to decide whether it's inappropriate. My own personal view is yes, that is inappropriate. That more of the insurance dollar should go to the victim and less to the lawyers.

SENATOR CARDINALE: What do you think would be an appropriate kind of amount? What would not offend your sensibilities? What percentage should go to attorney's fees?

MR. ANGOFF: I would think a quarter on both sides wouldn't offend my sensibilities in the aggregate.

SENATOR CARDINALE: Quarter on both sides? Do you mean a quarter of the money that the insurance companies pay out?

MR. ANGOFF: Correct.

SENATOR CARDINALE: Totally?

MR. ANGOFF: That's--

SENATOR CARDINALE: Should be moneys that go-- So 75% of the payout should go to victims, is that what you're proposing?

MR. ANGOFF: Yeah, I mean that's-- You can argue about

the, obviously you can argue about the specific number, but I think that there's a consensus among people on all sides that too much does go to lawyers and not enough of the insurance dollar to victims.

SENATOR CARDINALE: So that if we had a bill before us that said of all of the insurance moneys, however it gets split up, only 25% can be paid to attorneys?

SENATOR LESNIAK: How could you do that, Senator Cardinale?

SENATOR CARDINALE: Well, I don't know. People are talking about doing a lot of things.

SENATOR LESNIAK: How can you do that? I mean in any particular case it may be efficacious and efficient to expend a large amount on defense costs. In other particular case it would be totally inappropriate. How could you pass a general rule that would apply to the overall practice of the industry? That would be--

SENATOR CARDINALE: I don't think I totally understand your question, but let me rephrase mine.

SENATOR LESNIAK: I'm sure it's not very constitutional, that's for damn sure, but--

SENATOR CARDINALE: Let me rephrase mine. The witness has indicated that he thinks too much money is being devoted of this total insurance dollar to legal fees. He's also said that his -- he and representing his organization, they feel that 75% of the money should go to victims. Now my question very simply, if we had a bill that would accomplish that goal--

SENATOR LESNIAK: Social--

SENATOR CARDINALE: However you would call it, would his organization be in favor of it? I'm not saying I'm in favor of it. But would his organization favor such a bill?

MR. ANGOFF: Quite possibly. Their one -- and I don't dismiss the constitutional problem at all, but that concept is one which we would consider very seriously. One idea is, for example, as far as defense lawyers' fees are concerned, when an

insurance company comes in and asks for a rate increase, that there could be a law that require that only 25% of that rate increase be allocated to defense lawyers' fees.

SENATOR CARDINALE: You're limiting your comments to defense.

MR. ANGOFF: No. Limiting plaintiffs' lawyers' fees is old news. That's been -- I mean everybody is talking about limiting plaintiffs' lawyers' fees. In New Jersey, as I said, they're already limited to the greatest extent of any state in the country. What our position is--

SENATOR CARDINALE: What are they?

MR. ANGOFF: They're a sliding scale.

SENATOR LESNIAK: The effective rate is about 25%.

MR. ANGOFF: As opposed to, for example, I hear in some of the southern states it is 50%.

SENATOR LESNIAK: It's a third of the first $250,000, Senator, of the net recovery and then-- I don't usually get above $250,000 so--

MR. ANGOFF: But the point is that those who have suggested limiting plaintiffs' lawyers' fees, limit it to plaintiffs' lawyers' fees and it is our view and I think the view of--

SENATOR LESNIAK: What's good for the goose is good for the ganger.

MR. ANGOFF: That's right. If you're going to limit plaintiffs' lawyers then limit defense lawyers too. Now, there may be good arguments for limiting neither. But if you're going to limit one you should limit the other.

SENATOR LESNIAK: How does your organization feel about dentists' fees.

MR. ANGOFF: I hear dentists are having a very tough time, that there's too much competition, too many technological advances. So I don't know. We take no position on that.

SENATOR CARDINALE: We're going into all other kinds of lines of work.

MR. ANGOFF: That's right. We don't want dentists' fees limited.

SENATOR CARDINALE: In your thing here you have a little treatise on experience rating.

MR. ANGOFF: Correct.

SENATOR CARDINALE: Are you familiar with what's happening to the JUA claim in New Jersey currently?

MR. ANGOFF: No, I'm not.

SENATOR CARDINALE: The JUA was a-- You know what assigned risk is?

MR. ANGOFF: Yes.

SENATOR CARDINALE: JUA is a substitute in New Jersey for the assigned risk.

MR. ANGOFF: Correct.

SENATOR CARDINALE: Would you suggest that if we had such a claim that it pay its own way, that the experience rating of people within that claim be the basis on which the premiums are calculated?

MR. ANGOFF: I'm sorry. I don't understand the question.

SENATOR CARDINALE: Well, currently -- let me explain it to you, I realize you're not from New Jersey, are you?

MR. ANGOFF: Yes, I am. I spent 18 years--

SENATOR LESNIAK: I'm from New Jersey and I don't understand, so--

MR. ANGOFF: I'm from Clifton, New Jersey. I spent 18 years in Clifton, New Jersey.

SENATOR CARDINALE: I think you were on the Committee when we did this, as a matter of fact.

SENATOR LESNIAK: I know when we did it. I don't understand the question.

SENATOR CARDINALE: Well, one of the issues that was before us at that time was exactly the issue that you make. That those people who would be in the assigned risk, or whatever you call that plan, you can call it by any name, the high risk

driver, or the high risk person in anything, and I think you talked about it in several categories. Should those high risk people pay a premium that is dictated by that risk? In other words, contribute to a pool of money sufficient that the claims can be paid from that pool wherever they happen to fall? In other words, the high risk driver is put into a particular category and their premium be such that it doesn't impact on the safe driver?

MR. ANGOFF: In general, yes, we favor that type of system. It may not-- I mean there may have to be some degree of cross subsidization but in general, yes. We favor experience rating. It has-- I mean, New York just implemented regulations to experience rate doctors and I think that they're working out.

SENATOR LESNIAK: Let me ask Senator Cardinale one question first, if I may, Senator. Are you saying that the JUA -- the population of the JUA contains only those high risk drivers?

SENATOR CARDINALE: No.

SENATOR LESNIAK: Okay.

SENATOR CARDINALE: He's talking about experience rating and I realize that there's more to the JUA than that.

SENATOR LESNIAK: Okay.

SENATOR CARDINALE: But at the same time, when we dealt with this issue, and I made the suggestion why not charge a premium such that these high risk drivers would be paying their own way, whoever the high risk drivers were--

SENATOR LESNIAK: Senator, I may very well agree with you on this issue, but we're not talking about auto insurance now.

SENATOR CARDINALE: No, the issue was, and it's part of his paper-- The issue then was, and I was going to get to that question but I see I have to address my questions to you. Maybe he'll want to answer them then. The premium would be so high--

SENATOR LESNIAK: I was here all morning, Senator.

SENATOR CARDINALE: The premium would be so high--

well, you know, some of us have lots of responsibilities. But, by the way, civil service reform, for your information, was reported out today.

SENATOR LESNIAK: I know, with everyone's agreement.

SENATOR CARDINALE: With everyone's agreement. The total compromise.

SENATOR LESNIAK: You did a great job, Senator Cardinale.

SENATOR CARDINALE: And maybe we can do the same thing with insurance. But I think both sides need to be represented before you can begin to compromise.

SENATOR LESNIAK: Both sides have been represented. Unless you don't consider Senator Gagliano able representation.

SENATOR CARDINALE: I don't know about on the Committee. I didn't think Senator DiFrancesco was here this morning either, so I think--

SENATOR LESNIAK: By his own choice.

SENATOR CARDINALE: So I'm now representing the other side.

It just seems to me that the rate would be so high that if only those who have had malpractice claims against them, if somehow you made the distinction that those physicians only, or malpractice payouts on a policy as claims can be made by anybody. But if only the drivers who have accidents, it would only seem to me that the safe driver, the person who hasn't had an accident for 25 years should pay nothing, and the person who has an accident should pay the whole cost of the accident.

SENATOR LESNIAK: Senator, Senator.

SENATOR CARDINALE: That seems to defeat the theory of insurance. Isn't insurance spreading the risk over all of these people?

MR. ANGOFF: Yes, it is, but spreading the risk among people who to the greatest extent possible are of equal risk. Not spreading-- Again, to the greatest extent possible not mixing unequal risks. The point, though, you bring up about pure

experience rating, I agree with, you cannot do pure experience rating. For example--

SENATOR LESNIAK: That would be one each individual by themselves.

MR. ANGOFF: You can't do pure experience rating, medical malpractice for example, but you can have a system of credits. You can do more than what's going on today, which is just total disregard in many states, medical malpractice, for example, of an individual's experience. I think New York just implemented these regulations and I'm told that they are working out in medical malpractice.

SENATOR LESNIAK: Senator Cardinale, let me--

SENATOR CARDINALE: But you see this seemed to me--

SENATOR LESNIAK: Senator.

SENATOR CARDINALE: The reason I picked this particular thing up, it seemed to me to be an inconsistency between this experience rating position that you're taking and, at least a philosophical inconsistency, and your position with respect to joint and several. Because someone who is a very low risk on their own may become a high risk company when we have that particular kind of principle involved. Do you understand what I'm saying?

MR. ANGOFF: I think so.

SENATOR CARDINALE: I'm sure you've heard it before.

MR. ANGOFF: No, I've never heard it before. I've never heard that point brought up before. You're saying that-- I guess I don't quite understand it.

SENATOR CARDINALE: I'm saying, and I think you may have heard it this way because I heard it before, and I go to some of the same meetings that you do, I'm sure.

MR. ANGOFF: All right.

SENATOR CARDINALE: That if Coca-Cola or Company X, which is a large company doing business with many, many other entities, and is a very responsible and very safe operation, given the principle of joint and several liability, the insurance

company is covering the acts of many less responsible, perhaps insolvent companies by virtue of joint and several being a principle that's involved. And that insurance companies aren't talking only about today's claims and today's payouts that they're making. They're talking about the risks as these legal principles come to the fullness of their being. So how can you say we should have experience rating on the one hand, and say that joint and several is something you want to maintain? They seem to be philosophically inconsistent principles that you're supporting.

MR. ANGOFF: I understand your argument. I don't think that they are philosophically inconsistent, and this is why: In joint and several in order for a defendant to be found liable, that defendant must be found negligent or to have made a defective product. The percentage of responsibility is a fiction that the jury is asked to implement in allocating the equitable share. But the accident would not have occurred but for the negligence of all defendants. If Coca-Cola and some other companies are responsible for one indivisible injury, in a real sense they're all 100% responsible. It's just that when there are a number of different defendants the jury does not allocate 100% to each defendant. It divides up 100 how it--

SENATOR LESNIAK: Basically what you're saying is that the percentage of liability is a way of measuring responsibilities between and among the defendants, but if that one particular defendant was not negligent, the plaintiff shouldn't have been -- wouldn't have been injured.

MR. ANGOFF: That's exactly correct.

SENATOR LESNIAK: Therefore in that sense that any one individual defendant is, in fact, 100% liable.

MR. ANGOFF: That's exactly right. Just the jury does not-- The jury is told to allocate responsibility among all the defendants who have been found to cause the injury and but for the action of each defendant the injury would not have occurred.

SENATOR CARDINALE: I understand that that's said. As

a practical matter, is it your position that that is what actually occurs -- that no one is found liable in the courts in New Jersey or elsewhere unless, unless there is real, absolute, positive fault on their part, and that without that fault the injury could not have occurred?

SENATOR LESNIAK: By a preponderance of the evidence is the standard of truth.

MR. ANGOFF: That's exactly what I was going to say.

SENATOR CARDINALE: Ah-ha. So now we have another principle that modifies that, don't we? So that if, for instance, I was one of three manufacturers of a piece of sporting equipment and an accident occurred in an institution that used all three brands of equipment. I could not possibly be held at fault unless it was proved that it was my equipment and something defective about that equipment. Is that the position that you hold is provided here in our laws currently, in our current tort law?

SENATOR LESNIAK: In about 99% of the cases that's correct.

MR. ANGOFF: That's correct.

SENATOR CARDINALE: In 99% of the cases.

SENATOR LESNIAK: Yes.

SENATOR CARDINALE: What about the other 1%?

SENATOR LESNIAK: The Dalkon Shield case in some states.

MR. ANGOFF: That's correct. I don't think this doctrine would be applied to sporting good manufacturers, but, for example, DES cases in California.

SENATOR LESNIAK: DES, not the Dalkon Shield, DES.

MR. ANGOFF: There's the market share theory where because you cannot identify the manufacturer of the pill that the mother took 30 years ago that causes cancer in the daughter today, all companies in the market are responsible to the extent of their market shares. Now--

SENATOR CARDINALE: Even if they never were at fault

and they never caused any injury.

MR. ANGOFF: Two different issues there. They all were negligent in making DES. It is true that the company -- that there's no causation with respect to the companies that did not make the DES that the individual mother took, but there's no way to prove it.

SENATOR CARDINALE: So if there's no way to prove it--

MR. ANGOFF: But that's not--

SENATOR CARDINALE: What do you do in a murder case when there's no way to prove it?

SENATOR LESNIAK: Senator, Senator, that's a very unusual exception. We're trying to deal with broad issues here.

MR. ANGOFF: It's not adopted in New Jersey.

SENATOR LESNIAK: That deal with, you know--

SENATOR CARDINALE: Senator, I don't think it's--

SENATOR LESNIAK: --affordability. That is one case that you're taking out. Please, we were here all morning. You know, I'm here all afternoon. I really don't want to get on a dissertation on one fine point when we have so many very important broad issues and so many problems that have to be solved in this State.

SENATOR CARDINALE: Senator, I do think we have a lot of problems that need to be solved in this State. But I can't sit here and have a witness say something which is totally contrary to the total thrust--

SENATOR LESNIAK: I can't have somebody ramble on with questions that are not pertinent to the public hearing that we're having today.

SENATOR CARDINALE: --of everything that is going on with respect to joint and several liability all over this country.

SENATOR LESNIAK: Ask him questions about joint and several liability.

SENATOR CARDINALE: Well, I was.

SENATOR LESNIAK: No, you haven't yet.

SENATOR CARDINALE: I was pointing out the inconsistency in one part of his testimony, which is submitted in writing, and the part that he gave verbally. And since you and I are the only Committee members here, and we disagree on it, I think we can just agree to disagree and let the witness go.

SENATOR LESNIAK: Fine, thank you.

MR. ANGOFF: Senator, if I might just respond with two points on joint and several.

SENATOR LESNIAK: I don't know that we disagree. We just disagree with your line of questioning, Senator, that's all.

MR. ANGOFF: The first one on joint and several goes back to what I first said, which is that you've got to get the data to find out how often-- Obviously joint and several is an issue on which reasonable people, because you are obviously both reasonable people, disagree. In order to find out what to do about it, if anything, you've got to get the data and find out how often a defendant who is judged to be 10% liable say ends up paying 100% or 80% of 50%. There may be a problem and there may be a legitimate reason for changing the law but first you need to get the data. I agree, I think it's the toughest issue in the whole line of limits on compensation.

The second point is this: Now matter how you cut the issue of joint and several there's going to be some unfairness. It is unfair-- I agree with the insurance industry that it is unfair for a defendant that is held to be 20%, that the jury finds is 20% responsible to end up paying the entire judgment. First you want to find out how often that happens, but assume it does; yes, that's unfair. But what we have always said in this country is that in cases where there is some unfairness it is better to let that unfairness fall on the negligent defendant, the wrongdoer, than the totally innocent plaintiff. The alternative is in that type of situation for the plaintiff just not to get 80% of his or her damages. So I think both situations are unfair. I think the way we do it now is less unfair than the way that you, apparently, would like to do it. But if you do

decide to go ahead and do it that way, I would hope that you would set up some type of alternative compensation system to take care of the asbestos victims, for example, those type of people would be the ones who would be most severely injured by the modification of that doctrine.

SENATOR CARDINALE: The Chairman doesn't want me to respond to you.

SENATOR LESNIAK: No, no, Senator.

MR. ANGOFF: Well, thank you for listening.

SENATOR LESNIAK: Senator, do you have any other questions?

SENATOR CARDINALE: No. I, you know, I just don't understand why, with all due respect to the Chair, why the witness' repetitive statement of his position was not wasting the time of this Committee and why somehow--

SENATOR LESNIAK: I didn't say it wastes the time of the Committee. It's wasting my time.

SENATOR CARDINALE: Well, it was-- Okay. Whereas my questioning of him on what is probably one of the tougher problems that we have to face--

SENATOR LESNIAK: Shall we go on? Thank you. Thank you very much.

MR. ANGOFF: Thank you very much, Mr. Chairman. Thank you, Senator Cardinale.

SENATOR LESNIAK: We have an area, and I want to thank those of you who have been here since early this morning who have stayed around to testify on bills that I have proposed and Senator Cardinale have proposed with regard to both insurance exchanges and risk retention in their attempts to help solve the capacity problem and hopefully do something with regard to the availability of insurance in the State of New Jersey.

In that vein, I want to thank you very much for changing the schedule. If he's still here, James Johnson from LeBouef, Lamb, Leiby and MacCrae.

J A M E S F. J O H N S O N: Good afternoon.

SENATOR LESNIAK: You're not going to get off that easy, Mr. Johnson.

MR. JOHNSON: Oh, I'm sure of that. I have no doubt about that.

SENATOR LESNIAK: We have your prepared testimony. I would hope that you would be able to summarize it, giving first a brief background. I think Senator Cardinale is right in this regard, a brief background of your background on these issues and how you feel that New Jersey can either change its laws or its policies in that regard, with regard to capacity.

MR. JOHNSON: Fine. I'm a lawyer. I practice with a law firm that has offices in New York and New Jersey and a few other jurisdictions. I've specialized in insurance regulatory and other types of insurance law for about 20 years now and have had the privilege of advising a large number of American and alien insurers and reinsurers, brokers, agents, and consumers in the insurance area. Part of my responsibility has been to track legislative developments throughout the United States and I have spent a significant amount of my time specializing in surplus lines area. We are, our firm happens to serve as general counsel to Lloyds as well as to other insurers and reinsurers. As well we do a significant amount of work for the Risk and Insurance Management Society, which the large corporate buyers of insurance. So we're sort of all around. Rather than advocate anybody's views I said I was going to try to take this opportunity to appear more or less as a technician.

SENATOR LESNIAK: That's very good and that's one of the reasons why we called you. Senator Cardinale wasn't here, but I'm sure he will read the testimony. Senator Cardinale, the Commissioner--

SENATOR CARDINALE: If they ever print it.

SENATOR LESNIAK: Huh?

SENATOR CARDINALE: If they ever print it. They're a little bit behind.

SENATOR LESNIAK: Commissioner Merin gave testimony

of, I guess it would be fair to categorize it as saying very much opposed to risk retention groups and the danger of allowing businesses to form together to insure their own risk. Mr. Johnson, you've heard that testimony.

MR. JOHNSON: I did indeed.

SENATOR LESNIAK: What are your views on that testimony, and on that issue?

MR. JOHNSON: I strongly support Commissioner Merin's views that it's essential to have a solvent insurer. I think that there is a tremendous danger of letting unregulated, unsupervised and untrustworthy groups of insurers try to peddle their wares without any knowledge whatsoever what their financial status is.

However, to permit groups of insurers to come together and form an insuring entity has been going on forever. The old mutuals were originally formed this way. And it is a traditional means of establishing a risk bearing entity. I think properly regulated it's an excellent idea. I disagree with the Commissioner in being opposed to it. I think there's a certain amount of desire to be consistent with the NAIC view of risk retention acts are bad because the Federal government is involved, which I think is primarily their main reasoning for it. I do believe that another means of performing this function is to encourage the creation of captive insurance companies.

Several states, going back to the early '70s when Colorado passed the first captive insurance law have developed independent statutory systems whereby groups or individual companies, if they wanted form what is called a pure captive of just insurers, the parent and its affiliates, have gotten together to form actual insurance companies. But because they are forming and insuring only the entities that created them, there is an understandable reduction in the amount of regulation that's required. For example, if you were going to form a captive, as for example, the oil and gas industry or the oil industry did in Bermuda, the gas and electric industry has

elsewhere, why do you have to regulate the forms and the rates that they charge each other? The whole issue of deductibility and the IRS issues are no longer a matter of concern any more. And so it's a question of let them pay their money and set up their self-insuring mechanism, which essentially a captive would be, in their own way.

SENATOR LESNIAK: What about their solvency?

MR. JOHNSON: No, that's the point. Everyone of these states has a requirement that they maintain a certain degree of solvency. But figure out what happens when the company, if it should, goes bust? It doesn't mean that the insured doesn't get paid or the-- because the insured is one of the founders. He just has to pay the third party. If he is, and this is why Vermont differentiates between big insureds, owners of captives, and little ones.

SENATOR LESNIAK: I was going to say what about the small mom and pop?

MR. JOHNSON: The small mom and pop has got to have much more stringent regulations for solvency than the big guys. No question in my mind about that. Vermont has established a unique category called industrial insured captive, and I'll be pleased to provide Mr. Davis, I've brought copies of the Vermont law as well as the new Hawaii law that just was enacted a month or so ago, which is the latest version of this. And I'll be glad to give him a copy of these laws. They work. And the interesting situation right now is that although most companies have been establishing -- or associations or whatever -- have been establishing captives in Bermuda and elsewhere, there's a nice little sneaky change in the new tax reform bill which is going to make that much less advantageous for captives owned by Americans. And I think that you're going to see that as Americans now decide to set up captives -- American industry -- they are not going to be so anxious to go to Bermuda. They're going to want to go to a state. Right now the most liberal state in the country in this regard, most permissive, is Vermont. I

see no reason why New Jersey cannot replace Vermont or certainly compete with Vermont in attracting this very important and very valuable self-insurance type of business.

SENATOR LESNIAK: How come our New Jersey Business and Industry Association, and I don't see -- think they left the room -- or our Chamber of Commerce or our major industries haven't come knocking down my door or any member's door saying that we ought to do this?

MR. JOHNSON: I can't answer that, sir.

SENATOR LESNIAK: I can't answer it either.

MR. JOHNSON: I don't represent them.

SENATOR LESNIAK: Okay.

MR. JOHNSON: Another issue that came up this morning was the question of the exchanges coming in New York. Again, it seemed to me listening to Commissioner Merin and Mr. Jackson, that really that their concern with the exchanges was that they didn't know how to treat them. My response to that is tell them how. That is what a Legislature is to do. Tell them which way they should be treated -- should they be treated as an entity or should they be treated as separate syndicates? Now, Senator Cardinale's bill, which from what I've read it appears to be the adaption of the model NAIC provision on exchanges, is certainly the way that most of the insurance commissioners have decided to treat this issue.

SENATOR LESNIAK: As surplus lines only though?

MR. JOHNSON: That's right. As surplus lines. They can come in as admitted, if they want to, but you have to have a separate type of legislation, I think, to permit that type of organization to come in, which can easily be drafted. I mean, it's just a question of if you want to do it. I see no harm in doing it.

SENATOR LESNIAK: But the Commissioner and Jasper Jackson said that they're really interested in coming in to write as admitted insurers. Is that your particular--

MR. JOHNSON: From what I understand that could very

easily be. I think what they were trying to say is that they are very interested in writing direct insurance and not reinsurance, which was the original function of the New York reinsurance exchange.

SENATOR LESNIAK: Okay.

MR. JOHNSON: I know they've had a campaign nationwide to become eligible surplus lines insurers and they've succeeded, I think, New York has succeeded in 30 odd states. And they're continuing the pressure and the big main impediment has been the nonavailability of laws that recognizes their unique form of existence. I think it's a simple matter, as long as they're solvent and they meet the financial bona fides of any other insurer, why not? Good capacity and they have their own security funds.

SENATOR LESNIAK: They have their own security?

MR. JOHNSON: Yes, they do. The exchanges have their own security funds so they're--

SENATOR LESNIAK: Operated by?

MR. JOHNSON: By the exchange board of governors, or actually it's a separate group of people there.

SENATOR LESNIAK: Do they make annual reports or quarterly reports available to--

MR. JOHNSON: They have to file with Congress-- As I understand it, sir, -- there may be people here in the audience that know more about it than I do -- but the New York Insurance Exchange files by syndicate and then an aggregate report every year with the New York Insurance Department as does any other licensed insurer. In this case, (indiscernible). And they also maintain a security fund, which to the best of my knowledge the only entities which maintain security funds is Lloyds, and that is what it was modeled upon was the fact that Lloyd has a central fund.

SENATOR LESNIAK: Senator Cardinale?

SENATOR CARDINALE: I don't have anything to add. I think--

MR. JOHNSON: There is one--

SENATOR CARDINALE: I obviously support that proposal.

MR. JOHNSON: There is one line in that bill which I--

SENATOR LESNIAK: Senator Cardinale's bill?

MR. JOHNSON: Yes, in Senator Cardinale's bill which I point out only because it was put in there by the State, by the NAIC, and there's a requirement in there that the syndicates must obtain a non-resident New Jersey broker's license. Now the syndicate, which is-- I have just a draft of your bill, sir, but--

SENATOR LESNIAK: Yes, you're right.

MR. JOHNSON: On one of the lines there, I would respectfully suggest that you remove that. That was put in there during the deliberations of the NAIC because there was a feeling that there wasn't a way to have jurisdiction over syndicates, and I think that can easily be done in connection with the consent to serve as a process that will come in. One of the Commissioners said, "Let's make every individual syndicate have to get a non-resident broker's license" and everybody was so sick of the bill they said, "Go ahead. Let's get the thing passed. Forget it. We'll sort it out when we get to the Legislature."

SENATOR LESNIAK: Sounds familiar. But--

MR. JOHNSON: Line 60 and 61.

SENATOR LESNIAK: But wouldn't you need replacement language in terms of--

MR. JOHNSON: No, because every eligible surplus insurer, as I understand it, has to consent to service of process. It is, indeed, brought in by the non-admitted serve--

SENATOR LESNIAK: It's an amendment to the surplus lines bill that would be brought in.

MR. JOHNSON: I would just suggest that you may wish to delete that sentence, that's all, sir.

SENATOR LESNIAK: Okay. Senator Cardinale?

SENATOR CARDINALE: Just take note of that.

SENATOR LESNIAK: Did you have anything else to add?

MR. JOHNSON: I was-- My statement really basically covers the issues of-- I found it interesting this morning listening. I came away just up to know not so certain that there is a capacity problem in New Jersey. I'm hearing everything is being placed here and there. Everybody seems to not need anybody. No need for more insurers and we don't like to have these come in and we don't know what to do with them.

I think your surplus lines regulatory system in this State is archaic and should be changed. I think the law is outmoded. There's a new law and I suggest that you consider seriously replacing the law that you have with the new NAIC model surplus line law. My views on the surplus line guarantee fund are well known and you've done a good thing in this Committee already with Senator DiFrancesco's bill.

SENATOR LESNIAK: Oh, but that's not the NAI--

MR. JOHNSON: No, no. The NAIC had the wisdom not to even enact a surplus line guarantee fund to begin with.

SENATOR LESNIAK: No, but you said that there's a model regulatory--

MR. JOHNSON: There's a model surplus lines law which the NAIC enacted a couple of years ago, part of which is the exchange section you utilized.

SENATOR LESNIAK: Senator Cardinale, maybe you ought to look at that law in conjunction with your exchange law as well?

MR. JOHNSON: It's a good law and it is the result of vast compromise with industry and regulators. Took several years to come up with. That's a pretty good law.

There are other points. I think that basically when you're talking about capacity you've got to decide one of three things. You can either create new capacity by such things as authorizing the creation of these risk retention groups or captives or whatever, or having the government go in and provide capacity, which I think would, in effect, kill the private industry from playing in the same ballpark.

SENATOR LESNIAK: We are doing that, in effect, with some bills that we've passed, the excess liability fund for public entities, indemnification by the State of cleanup contractors.

MR. JOHNSON: The indemnification aspect falls in what I call the "you don't need capacity" situation where you, in effect, are taking away the liability of them and having somebody take care of them in a way.

SENATOR LESNIAK: Sort of the State being the insurer of last resort really.

MR. JOHNSON: It's sort of like tort reform in one way. Yeah. But the most important way is to attract capacity that's there here and not have it go to Connecticut or Alaska or someplace else. And that, I think, the way you're going to have to do that is to listen to the insurance companies to find out why they are less likely to come to New Jersey than to go to Texas. And one of the reasons I'm hearing is because it is more -- it's easier to predict your risks in other states than here. Part of it is your Supreme Court. Now your bill on--

SENATOR LESNIAK: Wait a second. You're going beyond what you were called here to testify. (Laughter)

MR. JOHNSON: Okay. I take the admonition. I will drop the issue. I was just hearing tort reform from a prior speaker and I just thought I could throw it--

SENATOR LESNIAK: What about my bill? Are you talking about in terms of interpretation of contract language?

MR. JOHNSON: Yeah. I think it helps.

SENATOR LESNIAK: Good. Okay.

MR. JOHNSON: I like it.

SENATOR LESNIAK: Thank you.

MR. JOHNSON: I'm interested in the issues that were raised on disclosure because the profitability figures, Mr. Angoff's proposal, the first one on using a cash flow disclosure model, I think is really dangerous. I think what it's going to do, which he wants to have all these figures, and I have no

objection whatsoever to the public seeing everything, that the proper way of evaluating the financial health of an insurance company is to see what they took in one year and what they paid out.

SENATOR LESNIAK: You have to know what their reserves were, too.

MR. JOHNSON: Of course. And that suggestion has to have relevance to that at all.

SENATOR LESNIAK: Well, you'd have to know both.

MR. JOHNSON: Yes, but you've got to know the whole thing and all that information is there. It's right--

SENATOR LESNIAK: I've seen charts prepared by the insurance industry on very nice publications that show much money they've lost that conveniently didn't include investment income, though, as well.

MR. JOHNSON: Well, then I don't think that's proper either. You've got to see everything, but then you've got to decide what you're going to do with that amount of data. I hear the Insurance Department saying they have no idea what they're going to do with it.

SENATOR LESNIAK: Well, in 1990.

MR. JOHNSON: Maybe. I don't know what appropriations you're planning at that time for the Department.

The other issue which I found interesting was the question of valuing tort reforms, finding out what are they worth. If you're going to come up with a pain and suffering cap, what is that going to be worth? And I think everybody wants to see that and nobody is able to come up with an answer. The NAIC has had an actuarial -- casualty actuarial task force struggling with this very issue for the past two years, and they are still -- and this is the actuaries from departments and industry -- they have still not been able to come up with an answer of what would joint and several mean. And really, I think the only way you can do it, even though it may not be the most satisfactory way, is to see what happens. Do it and see how the market

reacts.

SENATOR LESNIAK: Or look at what other states are doing and see if it works there.

MR. JOHNSON: Well, New York, for example, did price tort reform for medical malpractice.

SENATOR LESNIAK: Let's not get into this because--

MR. JOHNSON: That point I think raises some real problems. I don't know if we can come up with that answer.

SENATOR LESNIAK: We're trying. Okay. Thank you very much. I appreciate it.

MR. JOHNSON: My pleasure.

SENATOR LESNIAK: I would like to now here-- I was going to call somebody to refute your testimony. Maybe I should. I bet Tom Hart has something to say about-- No? He's not here? From the Independent Insurance Agents? Okay.

F. C H A N D L E R C O D D I N G T O N, J R.: A. Hart? Coddington (phonetic) is my name.

SENATOR LESNIAK: Oh. We have Tom Hart, H-A-R-T, from the Independent Insurance Agents of New Jersey.

MR. CODDINGTON: I'm an independent insurance agent. Tom A. Hart is my legislative chairman. I'm the President.

SENATOR LESNIAK: Are you here to testify?

MR. CODDINGTON: I excused him, so you've got--

SENATOR LESNIAK: You've excused him and you're going to testify in his place. Okay. I'm sorry, your name?

MR. CODDINGTON: Coddington, F. Chandler Coddington, Jr, President of the Independent Insurance Agents of New Jersey.

SENATOR LESNIAK: You don't have prepared testimony?

MR. CODDINGTON: I don't have prepared testimony. I sat through this morning's session though, and can respond to your capacity questions perhaps.

SENATOR LESNIAK: You agree with Commissioner Merin had to say?

MR. CODDINGTON: Some, not all. I'll make some comments if you will, if that's appropriate.

SENATOR LESNIAK: Sure, please.

MR. CODDINGTON: First of all, I'm President of the Independent Insurance Agents of New Jersey. We're 1600 independent businesses, entrepreneurial types, if you will, employing some 12,000 people in the business offering insurance services to the public, retail insurance services. I did happen to testify in Washington on the Risk Retention Act before Senator (sic) Florio. The lead witness the day I was there was Senator Lautenberg from New Jersey and he's the one senator that voted against the Risk Retention Act in the Senate interestingly enough.

SENATOR LESNIAK: He's not always right.

MR. CODDINGTON: His concern was, and my concern, and I think the Commissioner spoke to it, was the oversight of these groups as they're put together, and not too dissimilar to what the gentleman before me said. The concern we have is to make sure that they are financially solid. What Senator Lautenberg stated is that they should have their own separate guarantee funds. You cannot put these homogeneous groupings together, especially the mom and pop entities, and expect them to be capitalized properly, do the right job. We just can't see that happening. When you're talking about Ford and General Motors, and Chrylser, that's a whole different ballgame. When you get down to smaller entities, it's very tough to put together--

SENATOR LESNIAK: I would agree with you on that, only because it is difficult and they do not have the expertise. But then there's GAF and Union Carbide. Why should we protect them from themselves? I think they have enough capability.

MR. CODDINGTON: I don't disagree. I don't disagree with that as long as they do protect themselves from themselves, I don't have a problem with that. Interestingly enough--

SENATOR LESNIAK: Well, what if they don't?

MR. CODDINGTON: Pardon?

SENATOR LESNIAK: What if they don't? I mean what's that of our concern.

MR. CODDINGTON: Well, it is our concern if they come back and the injured party goes to them for recovery and they're belly up.

SENATOR LESNIAK: And if they self-insure and they're belly up, what's the difference?

MR. CODDINGTON: If there are assets there to attach there is no difference. But if there are not assets there then why should the insurance industry guarantees funds respond?

SENATOR LESNIAK: There are more-- No, no. They shouldn't respond.

MR. CODDINGTON: Absolutely.

SENATOR LESNIAK: They shouldn't respond.

MR. CODDINGTON: Correct.

SENATOR LESNIAK: They should not respond.

MR. CODDINGTON: I think we agree.

SENATOR LESNIAK: Okay.

MR. CODDINGTON: They should not respond. The separately created industry guarantee funds are for that purpose, not to step in and take care of these other--

SENATOR LESNIAK: Oh, I agree with you.

MR. CODDINGTON: Fine. I just wanted to reiterate that point.

But anyway on those small risk retention, you know, pools if you will, I just don't think they're, perhaps, appropriate.

SENATOR LESNIAK: I think you're probably right on that.

MR. CODDINGTON: As far as capacity is concerned, I really think, and the proof is in the marketplace, that with properly placed tort reform -- thoughtout tort reform, we're seeing evidence of it around the country, State of Washington, Michigan, Connecticut, Arkansas, the marketplace has responded.

SENATOR LESNIAK: New Jersey.

MR. CODDINGTON: New Jersey doesn't have tort reform yet.

SENATOR LESNIAK: New Jersey. Is not the market coming back in New Jersey?

MR. CODDINGTON: A little bit, a little bit. Not to the degree it is with the vigor in other states. And my point is with a good reform package of tort reform, the marketplace will respond as it is responding in these other jurisdictions.

SENATOR LESNIAK: Can you present this Committee with statistics to back that up?

MR. CODDINGTON: Yes, they're starting to become available.

SENATOR LESNIAK: Do you have those statistics?

MR. CODDINGTON: Example, in Connecticut I do know that one major company is reducing municipal insurance rates by the first of the year by a percentage.

SENATOR LESNIAK: What's the percent?

MR. CODDINGTON: I believe it's about 10% of municipal liability.

SENATOR LESNIAK: Rates that they increased by 100 or 300%?

MR. CODDINGTON: Sure. Whatever. But the marketplace is responding and responding positively and it's going to take a little time to sort through to see how the courts further interpret these changes as we go through. Joint and several is critical. We need relief in that area. Absolutely critical.

SENATOR CARDINALE: Senator, not to interfere. I did get a report along those lines and I didn't think of bringing it today. I wanted to share that with you. I will send you a copy of that.

MR. CODDINGTON: The joint and several is a collateral sources--

SENATOR LESNIAK: We're really not here to talk about tort reform as much as we really would love to.

MR. CODDINGTON: But it does relate, Senator; it does relate directly to capacity.

SENATOR LESNIAK: I understand that, but that's, quite

frankly, for another day. Maybe yesterday, today or tomorrow. Hopefully, but we're trying to get at other types of solutions as proposed by Senator Cardinale and myself.

MR. CODDINGTON: I think the-- we think the risk exchange would add capacity and with proper oversight by the Department, whatever other controls deem appropriate, I would add to capacity and we'd be for that.

Claims made, there was some discussion on that this morning. I think the need for claims made is directly proportionate to--

SENATOR LESNIAK: Capacity issue.

MR. CODDINGTON: Capacity issue vis-a-vis tort reform initiatives.

SENATOR LESNIAK: And the Commissioner is saying, let's wait and see what we do with tort reform, see how that shakes down, and then we'll take another look at the--

MR. CODDINGTON: I'm not disagreeing with him. And he did speak to our problem in my industry as purveyors of the product with our customer basis in the conversion process from occurrence to claims made, you know, a can of worms is being opened up. So as long as we can delay that and we get tort reform in to replace the need for claims made. See the claims made was an industry response to the crisis in the marketplace. But with tort reform as it is coming on board, that will lessen the need for that in my judgment.

However, as a caveat, I suspect claims made will for certain classes of business, pollution--

SENATOR LESNIAK: Be necessary.

MR. CODDINGTON: --be necessary. But not across-the-board. And interestingly enough one of our major domestic companies in New Jersey has announced that they are not going to offer the claims made product to their agency plan. A letter went out not too long ago. Because they're negotiated their reinsurance treaties such that they do not need it. So that's a positive from our perspective.

SENATOR LESNIAK: But they also don't--

MR. CODDINGTON: Sir?

SENATOR LESNIAK: But they're not underwriting many of the lines as well.

MR. CODDINGTON: The toughies, that would be true. I would agree with that.

The JUA question came up. I know it's not appropriate but--

SENATOR LESNIAK: You agree with me Senator Cardinale is out of line.

MR. CODDINGTON: No. (laughter) But really if we could see that JUA make its own rate, man, we'd solve a lot of problems in this State.

SENATOR LESNIAK: Yeah, you'd see 120 new legislators back in--

MR. CODDINGTON: It's got a big problem that's going down the chute and we've got to fix it and fix it quick. It has to be fixed and fixed quick.

I've talked about the comments I have.

SENATOR LESNIAK: Senator Cardinale, any questions?

SENATOR CARDINALE: No, only allow them to accept high risk drivers and charge them whatever it costs.

SENATOR LESNIAK: We'll work to come out togetner, too. Thank you very much.

MR. CODDINGTON: Thank you.

SENATOR LESNIAK: Howard Weiss from the -- or is it Howard Weiss or Peter Sweetland or both? Who wants to come up front? Peter.

P E T E R S W E E T L A N D: It was to be one or the other, because I had jury duty this week.

SENATOR LESNIAK: Is that right? Did you get picked?

MR. SWEETLAND: There are no trials in Mercer County this week and I was excused.

I'm Peter Sweetland, the President of the, attorney in fact, for the Medical Inter-Insurance Exchange of New Jersey.

Prior to this position I worked for 17 years for the Travelers Insurance Company, the last nine of which as an underwriting officer in commercial lines of insurance. During that period I was involved in the establishment of five different captives and, of course, now I'm dealing with the doctrine of captive in New Jersey.

SENATOR LESNIAK: That's established under State law.

MR. SWEETLAND: That's correct, and that is going to be part of what I'd like to talk about. I have a prepared statement and I won't read from it. I'll try to summarize briefly. But my first message is, you know, captives in general, that's a term that can cover a multitude of approaches to insurance coverage. It simply means that those that own the company are the primary client. They might not be the only one. In our case, they are our only client, the individual physicians and surgeons of New Jersey.

SENATOR LESNIAK: Well, if they're not the only one, then they're insurance companies, aren't they?

MR. SWEETLAND: Well, we can be a captive and an insurance company both, and we are. That's really the point I want to make. You can go from one end of the spectrum, which probably is the risk retention approach, all the way to a fully capitalized, organized, and regulated insurance company. We are the latter. We are a reciprocal operating under the laws of New Jersey and I will comment on the bill dealing with reciprocals before I'm through.

I'd just like to point out that I think one of the reasons for enthusiasm with these variations, such as off-shore captives or risk retention programs, is the ability to avoid regulation or at least minimize it, the ability to avoid some taxation, and perhaps to some additional extent to lessen the amount of money you have to put up to begin with. And if I have any message for you at all it's that the problem doesn't go away merely by the existence of a captive.

SENATOR LESNIAK: I understand that. But those areas

that you identified, though, they're very critical and relevant to the ultimate-- (According to log loss of couple words.)

MR. SWEETLAND: --company were less than a million dollars for us, yet we started with a capitalization of 20 million.

SENATOR LESNIAK: But isn't that an additional inducement, the risk sharing?

MR. SWEETLAND: Well, I think there are some real benefits to the captive and I really-- Could I have a chance to run those down? I'm not here downing the idea. I just want to clarify that just involving the people who are insured in the running of the company isn't going to cure it all.

There are real advantages in terms of a number of things that were brought up today. You have direct identification of whether or not you've made a profit, and it flows back solely to those who are insured, the owners of the company. You have more control on the part of the insureds in the way the company is run. Our company, for example, has the majority of its board and committees constituted with physicians. They are a valuable input to technical issues such as the underwriting of other physicians, the handling of claims, all of that, it's a critical benefit. There are real cost savings. If you deal with a group sponsored captive such as we are, and you, in effect, have a ready-made market -- I don't mean to offend Mr. Coddington -- but you can do this without agents, without the need to pay for a middle man, and that's a significant saving, was in our case. Our average expense ratio is only 8% of premium. You can do things with the information. You can consolidate your data, use up-to-date computers, as we have, and answer virtually all the questions that were raised by Mr. Hngoff about the availability of specialty by-line data, cash flow results. We do all of that. I should add we report to the Department now the amount of our settlements as well as judgments, and that's relayed to the Board of Medical Examiners. This kind of thing is required for some companies. It is in our

case.

SENATOR LESNIAK: That's not disclosed to the public, though, is it?

MR. SWEETLAND: It is not. The way that-- And this isn't a regulation set forth by the Legislature. It is reported through the Department to the Board of Medical Examiners.

We also have better control over our defense attorneys. That subject came up. You want a piece of data--

SENATOR LESNIAK: Why should you have more control than another insurance company?

MR. SWEETLAND: I think because we have the direct involvement of the insureds, because our policy requires our insured to agree to settlement before we make a settlement.

SENATOR LESNIAK: That hurts, too. That cuts both ways, doesn't it?

MR. SWEETLAND: It does. We've had no more than 30 cases where our insured has refused to settle and I'll have to admit to you we won a handful of those.

SENATOR LESNIAK: Lost some, too.

MR. SWEETLAND: Oh, we lost more than we won, but I don't think the expense was as great as the need to remove that provision from the policy. But as far as the point of control of defense counsel, I think it really has enabled us, particularly because we specialize, to focus on a small group of defense attorneys and, in effect, manage the case from start to finish and keep some control on their expenses. Our average cost in our ten years of experience for outside attorney fees is roughly 17% of indemnity paid. Now that's fees on all cases, won or lost.

SENATOR LESNIAK: How much per complaint filed?

MR. SWEETLAND: I'm sorry?

SENATOR LESNIAK: Do you have them broken down by case? What's your average defense cost by case?

MR. SWEETLAND: It's around 10 or $11,000. Our average indemnity payment is currently closing on $80,000.

SENATOR LESNIAK: And you win about 95% of the cases you try?

MR. SWEETLAND: That's correct this year. It's been anywhere between 80 and 95%.

Another area of economy is management of investments.

SENATOR LESNIAK: That's because I'm not trying them any more.

MR. SWEETLAND: I'm sorry?

SENATOR LESNIAK: That's because I'm not trying them any more. No free advertising.

MR. SWEETLAND: I would add one of the main reasons for that is when a case is desiring and should be settled we attempt to settle it. That's the facts and so--

SENATOR LESNIAK: Are you familiar with the hospital-- The hospitals also have an insurance exchange.

MR. SWEETLAND: That's correct. We are the two reciprocals within the State.

SENATOR LESNIAK: Okay. Are you familiar with the operations of the Princeton Inter-Insurance Exchange?

MR. SWEETLAND: Well, they're a competitor, but occasionally we are on the same case together, yes.

SENATOR LESNIAK: They don't have the same peer review procedure that you do in terms of settling cases, do they?

MR. SWEETLAND: Well, I'm sure they do medical review of the issues. They don't do it the way we do. They're staffed primarily with people from the St. Paul Insurance Company background and they do it the way that company did. They're the largest insurers of malpractice in the country.

I was going to go onto another plus, which is the ability to focus your investment management to your particular type of insurance. The forecasted payouts and really we have more ability to--

SENATOR LESNIAK: More flexibility.

MR. SWEETLAND: --to fluctuate in our investments to match our expected payouts. This has caused to have

significant-- Well, better than average investment performance.

And then the final plus I identify in there is the ability to do a better job of preventing loss. You have the motivation of your own insured group to analyze what went wrong and how to prevent it reoccurring. And you also have the motivation that perhaps their rates will go down if they will take heed of what's happened in the past.

SENATOR LESNIAK: Without regard to the rest of the world.

MR. SWEETLAND: I'm not sure I understand what you're driving at.

SENATOR LESNIAK: Well, if your policy is written on a particular specific experience of that insured.

MR. SWEETLAND: Well, as a reciprocal we share in the losses of the entire group, so and if it's a given specialty attempts to cut down the sources of loss within that specialty they can affect a reduction in their rate. This has actually happened with anestheseologists in our experience.

In addition, I do comment on disadvantages.

SENATOR LESNIAK: I'm sorry?

MR. SWEETLAND: I comment on the disadvantages of a captive. I think the fundamentals can't be ignored. If the group gets together and thinks this is all just the creation of the insurance industry, this problem, and all we have to do is manage our own affairs, and let's pick a nice low number to start with, they're headed for disaster. This is not a crusade. It's a real insurance business and they have to understand what they're doing.

They can be too small a group. No matter how intent they are on doing it right, if they're not big enough for the whole idea of insurance to apply to spread the loss, they could do well for quite a while. A group could get together that says we have no past loss experience so we really ought to do our own thing. They get hit with one big whopper and it's done. One way to avoid that, of course, is to purchase reinsurance, but if

you're a small group and you go out and purchase reinsurance you're apt to have them running your company for you. They're going to wind up taking the biggest chunk of the exposure, the big catastrophic hit. And they will not reinsure you--

SENATOR LESNIAK: The savings is minimal.

MR. SWEETLAND: --unless you use their rates.

So in general my comments on reciprocals or captives in general is they're a positive thing. But they need to be entered with caution. We've been in business for ten years. I think you would call us successful. Pessimists might say our very continued existence is success. They never thought we'd be around this long. We have broken even, I would say, over our period of time, but we've only done that after getting rate increases. There still is an underlying trend that we can't get around just by virtue of all the economies we've accomplished.

If I could, I'd like to talk to a couple of things that have come up. One, specifically S-2467, a bill in which reciprocals are enabled. This is a replacement of existing regulations. As I say, we are a reciprocal. We've already come into being. I've only read this a couple of times. I'm not an attorney myself, but it's in my view--

SENATOR LESNIAK: Couple times more than I have.

MR. SWEETLAND: In my view this strengthens the regulations of reciprocals. It does not encourage anybody new to decide to be a reciprocal. It particular confines those who are not big enough to become non-accessible. It requires that their financial backing be very substantial. I mean a multiple of what ours is. So I think it will not encourage new outfits to become reciprocals. I apologize. I think it's a good idea to be more specific about what a reciprocal ought to do. It's very vague right now in the Code. But frankly, we have to review this further, but if it were--

SENATOR LESNIAK: Now would the--

MR. SWEETLAND: --to exist it might even encourage us to change our form.

SENATOR LESNIAK: We're looking at other proposals.

MR. SWEETLAND: Okay. As far as the enablement of the exchanges to become admitted as surplus lines carriers, I strongly endorse Senator Cardinale's bill. We have had direct conversations with the New York Exchange. The professional liability insurers across the country have some problem with reinsurance availability. There is the question of whether or not we should form a syndicate. And, of course, we cannot do so and benefit here in New Jersey if the syndicate can't be admitted here. I did have conversation with the president of the Exchange just a few weeks ago and I didn't get any indication that they'd rather be a full lines as opposed to a surplus lines carrier.

On the issue of claims made, I hate to contradict the Department, but there are several admitted carriers writing professional liability on a claims made form.

SENATOR LESNIAK: That's what I thought.

MR. SWEETLAND: I expect your own legal liability insurance is claims made.

SENATOR LESNIAK: I thought it was.

MR. SWEETLAND: We just converted to a type of claims made form for our own coverages. I don't think the concept does that much for the policyholders, but we had to do it to satisfy our reinsurer. The fundamental plus of claims made is rating flexibility. It doesn't reduce cost at all. It's an accounting device. And it gives the company the advantage of catching up if they're in the hole. It does help the insured in terms of moving forward limits of liability.

That's my introductory comments. I'm sorry if I took too long.

SENATOR LESNIAK: No, you didn't take too long at all. Senator Cardinale?

SENATOR CARDINALE: Yes. I think this violates your rule, but it's in his statement. And I really, this prior fellow asked us to really study some of these factors like -- and one of

the factors there's a great deal of dispute about is, is there an increase in claim, and underlying rate of increase in claim, and can you, you know, as an insurer document for us what that underlying increase in claim has been for you? You're about as close to an impartial source, I think, as we can get because you're not a for-profit company and your experience is largely in New Jersey. What's been happening?

MR. SWEETLAND: Well, in our experience, and of course it is limited to professional liability for physicians and surgeons, we've had a definite increase in the number of claims. They have doubled in our ten years of existence. I have written to the Commissioner on that fact with experience, actually our rate filings included as well. I think the source oft quoted by those who disagree now admits there's certainly an increase in malpractice claim filings anyway.

I would caution that data -- jury verdict research data -- is just verdicts. It's hard to count what the real impact is if the others like us have learned when a case should be settled. There might be no change in verdicts and a dramatic increase in cases either dropped or settled. I certainly believe that's what happened in the technical liability lines, not just malpractice.

SENATOR CARDINALE: Now you say you--

SENATOR LESNIAK: Of course when you look at -- I'm sorry. when you look at increased claims you also look at the starting point as to whether your starting point was a valid measurement of legitimate claims being made or whether there were impediments to claims being made at that time that there are not now.

MR. SWEETLAND: Well, it is sort of a reverse of the argument that -- or a corollary to the argument that the system is more expansive. So I agree in that respect, but it reaches the same conclusion. we have more claims than we initially expected and it's hard to handle.

SENATOR LESNIAK: Right. But if legitimate claims were institutionally not being -- because of institutional impediments

were not being brought, that's something to consider when viewing the history of increased claims.

MR. SWEETLAND: I accept that but--

SENATOR LESNIAK: I'm not saying that's the case, I'm just saying that you have to look at that.

MR. SWEETLAND: All you have to look at is that win ratio you just quoted. Certainly in professional liability the number of cases won for the defense is much higher than the average in all tort law. Studies have been done by the jury -- well, the Rand Corporation to corroborate that.

SENATOR CARDINALE: I think Senator Lesniak was getting at my next question, but I don't think he did it totally. If you've doubled in ten years in the claims made, you must have some idea of what has caused that doubling. Now maybe you were starting at a false reading, but are there more incidents, or is it a change in the facility to win money, whether it be through verdicts or through settlements or any other means, that is responsible for, or is it some other factor that is responsible for those increases in claims?

MR. SWEETLAND: No. I think it is certainly an increase in exceptions. I've been involved off and on through my entire career in the handling of professional liability insurance. The frequency has continually gone up. No matter where your starting point is, you might find some periods of leveling, but it continues to ratchet up. There's an expansion of the type of allegation presented. For us the allegations of missed or delayed diagnosis have increased many fold.

SENATOR LESNIAK: Is there an increase in the number of doctors over that period of time?

MR. SWEETLAND: Not in anywhere relative to the increase in claims.

SENATOR LESNIAK: How much is the increase in the number of doctors over that period?

MR. SWEETLAND: I don't have the exact data with me, but clearly the number of doctors in New Jersey has less than

doubled in the last 10 years compared to the number of cases we've seen.

SENATOR LESNIAK: But there has been an increase in the number of doctors.

MR. SWEETLAND: No, but the numbers I'm citing are per 100 doctors, so we've taken that variable out.

SENATOR LESNIAK: How about population?

MR. SWEETLAND: As far as the pop? I can't say. We haven't measured that part, but in terms of the number of patients a doctor sees, that's fairly constant apart from what's happened to the population. We think we have the same base when we talk about incidents per 100 insureds over our 10 year span.

SENATOR LESNIAK: You think the number of patients that doctors see now is the same as it was 20 years ago?

MR. SWEETLAND: I can't be real-- I can't give you a reliable answer to that.

SENATOR LESNIAK: Doctors making housecalls 20 years ago? I don't-- maybe not 20 years ago, they were 30 years ago.

SENATOR CARDINALE: I don't think you can really get at that because if--

SENATOR LESNIAK: In any event, Senator--

SENATOR CARDINALE: They're all full-time doctors.

SENATOR LESNIAK: We are looking at a very limited-- I think your statistics are probably the best because it's the -- it's isolated to one particular profession. I don't know what we could do with that except make judgments regarding that particular problem with regard to that.

SENATOR CARDINALE: You do have a procedure, I think you do -- let me just ask it -- whereby you can exclude from coverage certain practitioners on the basis of what they do. In other words you have a program to diminish risks.

MR. SWEETLAND: Based on their own actual experience, yes. We cancel doctors. We surcharge other doctors. We do out some limitations on coverage, but essentially--

SENATOR CARDINALE: So to an extent you're doing what

this consumer fellow said should be done. You're taking the worst ones and either charging them more or getting them right out of your group.

MR. SWEETLAND: That's right. We had a merit rating approach long before the New York proposal.

SENATOR CARDINALE: I have nothing else.

MR. SWEETLAND: Okay. I guess I'm through.

MR. DAVIS (Committee Aide): Thank you.

SENATOR CARDINALE: Do you have someone else?

MR. DAVIS: Yes, we've got two more. Do you want to wait until the Chairman comes back before we call them?

SENATOR CARDINALE: Where's he gone?

MR. DAVIS: He'll be right back. Just a moment please.

SENATOR CARDINALE: Who are the two that are left?

MR. DAVIS: Stuart Rutenberg, is he here? Yeah, okay. And Michael Shay, right. Those are the two.

RECESS

AFTER RECESS

SENATOR CARDINALE: Stuart Rutenberg. Mr. Rutenberg, the testimony is being recorded and I'm sure that the other members of the Committee as well as the Chairman will read this as soon as it's been produced for us.

S T U A R T R U T E N B E R G: Good afternoon.

SENATOR CARDINALE: Good afternoon. Thank you for coming. You can go on.

MR. RUTENBERG: I don't have a prepared statement. I'm basically here just to testify to the benefit of the addition of exchanges and the increased capacity that they might provide for the State of New Jersey. As a representative of the Surplus Lines Association and an independent surplus lines broker, I have actively been solicited by at least two syndicates on the exchange itself whereby they have expressed sincere desire to write in New Jersey, whether it be as an admitted carrier, which

we heard earlier, or even as a surplus carrier. The wherewithal as how to come as a surplus carrier would be worked out later via legislation. But that is not the point in fact at issue here. The issue is the capacity situation.

In addition to providing capacity for those risks that the other carriers are actively soliciting and writing, they want to come in and write capacity classes of business that are difficult to place or unobtainable in the State of New Jersey at the present time. Also, we discussed earlier when the Commissioner spoke, we asked if MAP was a situation that was long-term or short-term. With the increased capacity that the exchanges might provide it would eventually, if not immediately, provide for an erradiction of the MAP because the classes of business that the associations and the exchanges are willing to write to date include day care centers, municipalities, and more important for my benefit, liquor liability.

Now, I've not heard one testimony today that has as yet stated that liquor liability has become viable via MAP. I talk to three, four hundred brokers a month and the first question lately is, "Have you placed any business through MAP for liquor liability?" and I've not received one positive response. That's not to say that MAP doesn't work. It's just to say that no brokers have placed business through it. The tavern owner is not looking to get business placed six months down the road. He needs liability today. So when they call us up they're looking for a solution to their problem today, not six months down the road. All I'm saying is that we do have at our disposal today the availability of viable markets with capitalization, which we feel are substantial enough, to meet the requirements of a writer, which by legislation could be passed virtually immediately.

SENATOR CARDINALE: Do you feel that the day after we actually get that signed into law that you'll be able to furnish liability insurance for the liquor industry?

MR. RUTENBERG: Yes.

SENATOR CARDINALE: Will that be only in very selective kinds of risks or will that be the general?

MR. RUTENBERG: No, very broadly based.

SENATOR CARDINALE: Very broadly based.

MR. RUTENBERG: I would say less than 2% would become non-eligible, and the non-eligibility would only be because of the prior performance of the risk itself, which is not unlikely in any class of business.

SENATOR CARDINALE: I understand the Commissioner and Jasper Jackson were here and expressed some reservations earlier today about our getting involved with this. Were you here to hear that testimony?

MR. RUTENBERG: Yes, I was.

SENATOR CARDINALE: Would you comment on it?

MR. RUTENBERG: I feel that the Commissioner's Department, the Insurance Department and the Commissioner's office have every reason to be concerned about the financial ability of the exchanges. However, as pointed out before by Mr. Johnson from LeBouef's, that these exchanges do have sufficient capitalization and they also have their own guarantee associations or guarantee funds, as you call it, which do provice for the potential insolvency of an individual syndicate on the exchange. Noting, of course, that syndicates are not the exchange in itself. Each exchange is constituted of a multitude of syndicates. Illinois, I think, is up to 12 syndicates right now and growing.

SENATOR CARDINALE: So therefore the question of the solvency of these it, at least in your opinion, is not something that should be of concern to us. Would you give us an idea, because we're not in the insurance business, any of us, of the comparative solvency of these exchanges as compared to individual companies that are currently admitted doing business in New Jersey?

MR. RUTENBERG: Well, you're asking for an opinion based upon not seeing the financial statements of the individual

syndicates at the present time. However--

SENATOR CARDINALE: Will you deal with those syndicates?

MR. RUTENBERG: Excuse me?

SENATOR CARDINALE: Do you deal with those syndicates at the present time?

MR. RUTENBERG: No, they're not approved in New Jersey yet.

SENATOR CARDINALE: So you don't do any business with them at all?

MR. RUTENBERG: Not yet, no.

SENATOR CARDINALE: All right. I thought you might be doing some out-of-state business or something with them.

MR. RUTENBERG: No. However, in response to your initial question, it might be safe to assume that related back to "Best's Insurance" which provides ratings on a yearly basis, it would be safe to submit the majority of syndicates would carry no less than what would be equivalent to a B plus rating, which is considered very good and certainly viable in the State of New Jersey.

SENATOR CARDINALE: What would be the disadvantage, possibly, of allowing those exchanges to do business in New Jersey?

MR. RUTENBERG: The same disadvantage that would be to allow any new company or allow any company which is financial impaired that which that the company might go insolvent by poor risk selectivity.

SENATOR CARDINALE: When it was recommended to me that I introduce that legislation it was recommended to me that it be worded in such a way that there's a number, in this case 35 million or 35 whatever, dollar figure be placed in there. That was an attempt to limit or to exclude from this approval that essentially would come with the legislation a particular exchange, which was reputed in the industry to be not as solvent as the others. On what basis does that opinion exist?

MR. RUTENBERG: The exchange you're speaking of is set up differently than the other two exchanges whereby in the past it has been refuted that some of the reinsurance that they accepted was not on as strong a financial basis as it could have been, and that's under investigation at the present time. I don't that that has any bearing to New York or Illinois exchanges where individual syndicates do have higher financial requirements for admission to syndication. And thereby also, when you allow an exchange as a whole or an entity into a state to become a writer, whether it become admitted or foreign, you would have the backing of this financial guarantee, which at this point is stronger than that of any of admitted or surplus carrier that comes in new.

SENATOR CARDINALE: Thank you.

SENATOR LESNIAK: I'm sorry. I don't have any questions. Thank you. Michael Shay from the New Jersey Citizen Action.

M I C H A E L S H A Y: Good afternoon, Mr. Chairman, Senator Cardinale. Excuse me. I have a cold so if I do not speak clearly it's probably because I'm nervous and I have a cold.

SENATOR LESNIAK: You don't speak clearly and I can't hear clearly, so we're in good shape.

MR. SHAY: We'll communicate effectively.

I'm here testifying under three hats. One, I'm the manager of the Central and South Jersey District of our Clothing and Textile Workers Union, which has about 5000 members located from New Brunswick south to Cape May, employed in industries ranging from health care products to tradiitional textiles such as dying and finishing sewing operations and weaving.

I'm also a Vice President with the New Jersey State Industrial Union Council, which is an affiliation of the industrial unions within the State of New Jersey. I'm also a board member of New Jersey Citizen Action, which is the largest labor, citizen, community, senior coalition in this State.

And before I go on, Senator, you should know that

probably we do not have attorneys, physicians, or dentists represented in an unusual numbers represented in the aforementioned three groups. (laughter)

SENATOR LESNIAK: Michael, with reference to your testimony, you start off by identifying the source of the problem. We've kind of heard over months and months and months about that, and we're probably all in agreement. What we're looking today is to have your view and your organization's view regarding the proposed disclosure laws, the proposed capacity issues that could, regardless of the source of the problem, help us solve it.

MR. SHAY: Okay, Mr. Chairman. I will not read from it. I will try to diminish my nervousness and go off the cuff.

SENATOR LESNIAK: It will be easier.

MR. SHAY: Perhaps. I'd like to point out that before I go on that I understand and our organizations and our membership understand that this is a complex issue. And as much as we would like to have our issues be black and white, fair or unfair, I don't think that the issues that faces the Legislature very often fall under those categories. They usually fall under categories of choosing between alternatives that are less fair or more fair or trying to avoid the more unfair alternative. And I think that's some of the issues that we have before us on this question today.

You've heard previous testimony that classifies or characterizes the issues as being around the crisis of affordability and availability, and we would certainly concur with that. Although I think testimony in some experience indicates that the availability element has diminished somewhat in the past several weeks, certainly there's no evidence that the affordability element has diminished at all and probably will not diminish until interest rates go back up.

I'd like to talk about, then, a little bit about some of the proposed remedies and on disclosure. We have the prepared testimony. I'll try to go off the cuff on it a little bit. The

last time I testified and the only one of three times I've ever testified before any committee was on the Job Retention Plant Closing bill, a very different issue, but the principle is the same. Part of the Governor's veto message, a veto that was sustained by the Legislature, was that we should not legislate in the dark, we should not, as they say in Tennessee, "Buy a pig in a poke." He said that we should set up a commission composed of industry, government, and labor to study the very complex issue, study it in depth, and report back before we attempt to legislate without knowing what the impact of that legislation would be. I think the principle holds true in this case.

We've heard ample testimony today, and I think that we all admit that understanding the income in terms of premiums taken in and the payout in terms of indemnities, in terms of settlements, in terms of reserves that have to be maintained and in terms of interest earned on moneys taken in, is something that is not well known or well documented within the industry. I think further that we've heard ample testimony that, for instance, that the Department, the business itself, have had their own actuary studying this problem of what impact proposed reform would have on premiums for two years, and these very professional and very technical people have been able to come up with what the impact of these proposed reforms would be on premiums.

I think we can quickly discern what the impact would be of some of the reforms on individuals. It's something that has not been testified today, either in terms of individual members of the New Jersey Citizen Action Coalition, or in terms of individual members of the Industrial Union Council, my union in particular, and I'll give you some anecdotal evidence and you can take it for what it's worth. I understand the problems with anecdotal evidence.

One of the two major crisis that face some of the textile industries has to do with the toxic effects of some of the chemicals used in the dying and finishing industry. There

has been a lot of legislation, lot of law come out regarding disposal toxics, the DEP regulations, the EPA regulations. But one of the things that has caused the industry to seek safer alternatives to the existing toxic substances that they use in the industry happens to do with joint and several liability legal theory. They do not want to take any chances that improper disposal of their toxic substances would somehow lead them to be severally or jointly liable for the disposal of those toxics. It's had a real impact in providing an incentive, along with all the other legislation, real impact in providing incentive to providing safer alternatives to the substances used in those industries. We find it much easier to get the attention of businesses on dealing with the issue of toxics in the workplace not only because of that legal theory, but if a substance somehow, it gets suggested in health and safety literature, as not only a carcinogen -- because a carcinogen usually has to deal only with the worker -- and an employer usually knows what the limits of their liability on an employee because of workmans. comp.

They are concerned, don't get me wrong. I don't mean to imply for a minute that they're not concerned about it. But I can tell you that their concern certainly intensifies and the rapidity with which they take action is expedited when the substance is not only classified as a carcinogen, but they talk about it being a mutagen or a teratogen as well, meaning that it affects chromosomes or has had some kind of demonstrated effect on fetuses. And I suspect that that's because children do not come under the classification of the workmans, comp system. So that if a parent suffers exposure that affects the unborn child or the born child, the employer does not know the limits of their liability under the present legal system because the child is not covered by workmans' comp. Goes through the tort system.

So we find it much easier and there's greater haste to deal with substances that have been labeled as teratogens or mutagens because of the open-ended liability to the employer.

SENATOR LESNIAK: Sir, if it was open-ended liability they would more inclined to not deal with that product?

MR. SHAY: They'd be more inclined to find a substitute for it.

SENATOR LESNIAK: Substitute for it.

MR. SHAY: Yes.

SENATOR LESNIAK: If it's predictable all they would have to do is measure the predictable loss versus the profit in using it and if they come out ahead, if it were purely an economical decision, if they were just interested in maximizing profits, then they may not look for a substitute.

MR. SHAY: Mr. Chairman, I would not characterize in a situation like this any employer as making a simple cost benefit calculation. I think they take in the tragedy involved.

SENATOR LESNIAK: Has that happened, though, in the past?

MR. SHAY: I think--

SENATOR LESNIAK: Cost benefit analyses have been made in those instances.

MR. SHAY: Yes, it does, and when they can predict their top-end liability as they can under workmans' comp. certainly based on a cost benefit analysis they're less likely to be as expeditious in taking action and finding substitutes as they are when they can't predict the cost. In fact, in those situations where it just impacts upon employees it may, in fact, just become a cost of doing business that they can factor in as they can any other cost. So they're less likely to act as rapidly conversely with the situation where they can't predict their costs and it does not become a cost of doing business.

So it has a real impact in terms of our members and the labor organizations that I work for and that I am affiliated with.

SENATOR LESNIAK: With regard to toxic torts.

MR. SHAY: Pardon me?

SENATOR LESNIAK: You're talking about toxic torts.

MR. SHAY: Yes. In terms of the coalition that I'm also am a member of, I think that anyone who is aware of the problems of toxic disposals within our State -- and I'm born and raised and still live in this State -- understand the benefits that have come out of the legal theory of joint and several liability. We know that if we limit that legal theory that for those non-Superfund designated areas where toxics are still a problem, toxic disposals are still a problem, if industry is not held liable for its cleanup, then it's going to fall on someone.

SENATOR LESNIAK: But there aren't any proposals to change the Spill Fund that I know of.

MR. SHAY: I beg your pardon?

SENATOR LESNIAK: There aren't any proposals to change the joint and several liability aspect of the Spill Fund that I know of so--

MR. SHAY: None that I know of either. I just--

SENATOR LESNIAK: Okay.

MR. SHAY: --believe that the legal principles are the same. That loss is going to fall on someone and I suspect that it is either going to be the individual municipality or the taxpayer.

We get back to testimony that was earlier given -- I forget James' last name -- but the point that he made. We get down into the issue of joint and several liability which I also concur with being the most difficult to defend in terms of its fairness, to have someone -- to have a jury decide that someone is 10% liable and may wind up paying 100% of the judgment. It just strikes against the precepts of basic fairness. But the point that he also made was that the alternative to that is to have that person go without 90% of the judgment, the person who is the innocent victim, is more unfair. And until we come up with a system that would meet that lack of fairness, an alternative that would meet that lack of fairness, I think that we have to continue to suffer under a legal theory of joint and several liability.

What I'd like the thrust of my testimony to be is to get back to the impact on the individual, whether it be the individual employee, the individual union member, the individual senior, the individual tenant, that these proposed reforms are going to have on the individual. We're not just talking about the industry. We're just not talking about affordability and availability. We're talking about limiting rights, constitutional and courtroom rights that have been enjoyed by individuals. If we're going to limit them, I think we ought to limit them only after extensive study of the industry. The proposals that have been put forth in terms of looking at the claims, and in my prepared testimony I go over again the same ground that Jay went over earlier. We need to have that information, I think, for the Legislature to do its proper balancing act, and that is to balance individual rights, corporate rights, government rights, society rights. I don't think you can perform that balancing act properly absent a good data base.

If the crisis of affordability and availability continue to be that, a crisis, then I think the best that we can do, and I think we ought to do it reluctantly, would be to take interim temporary measures until we collect and construct a data base that would allow that balancing act to be done in a serious and a studied manner.

SENATOR LESNIAK: Well, nothing we do is permanent.

MR. SHAY: Some things are a little more permanent than others. Some things are a little more difficult to change than others. And I think that since the industry itself, in this cycle of low interest rates, is, I think, responsible for putting out a lot of anecdotal evidence as to why these reforms should be undertaken that a quid pro quo is timely. That is, if you want us to look at limiting rights that individuals presently enjoy, to flatten out the cycle or the impact of the cycle that the interest rates have, then I think it's particular auspicious at this time to also look at the elements of disclosure, to allow us

to study exactly what kind of impact it would have on flattening those cycles out. And I think that would be an appropriate and justifiable quid pro quo.

SENATOR LESNIAK: What about-- I mean, it's nice to flatten cycles out.

MR. SHAY: I'm not sure that we can, but to minimize it.

SENATOR LESNIAK: I'm not sure we can either but okay. minimize the--

MR. SHAY: Peaks and valleys.

SENATOR LESNIAK: Thank you.

MR. SHAY: You're welcome.

SENATOR LESNIAK: Peaks and valleys. You're doing very well without your prepared testimony, by the way. But what if the end result is a cost that is still excessive and unaffordable?

MR. SHAY: The end result of what, Mr. Chairman?

SENATOR LESNIAK: Of whatever we do. There's still excessive in terms of most covering.

MR. SHAY: Then we go to Plan B.

SENATOR LESNIAK: Good answer. Senator Cardinale?

SENATOR CARDINALE: Well, a couple of points. One, in your prepared testimony you talk about the disclosures and you have been somewhat critical of some of the bills that have been introduced in that regard. I noticed that you don't criticize 2402.

SENATOR LESNIAK: Is that your bill?

SENATOR CARDINALE: Yes. But I'm prompted to ask a few questions. We hear whenever we talk to people, insurance commissioner types, people in government who are in charge of receiving this information, I never hear from them that they can't get enough information. I hear from them generally that they worry about having more information than they know what to do with. I hear from them that if they had all of that information and if they knew what to do with it, that the bottom

line on it is so what? You know, there's nothing-- they don't have any teeth.

SENATOR LESNIAK: Senator, that's not quite what Commissioner Merin's testimony was this morning.

SENATOR CARDINALE: Well, I wasn't here this morning. I haven't read it yet because it hasn't yet been typed, but it's generally true, and I think that even he has said on a number of occasions where I've been present, that he really has felt -- and before this Committee as a matter of fact when the last time he was Commissioner -- that he really has felt that they've got really the ability to get any information under our existing laws, despite having introduced one that gives them more ability, that they already have the ability to get more information. Now you make some specific statements on the bottom of page two and going on.

MR. SHAY: Which part of my prepared testimony? We have two documents. Is this on my statement or the financial disclosure?

SENATOR CARDINALE: This is the one.

MR. SHAY: Okay.

SENATOR CARDINALE: Starting with "furthermore," middle of the last paragraph on page two. What is this information that specifically that you're referring to here, what information and what laws are there that need to be changed so that information which is of use to them would be available and in a form, etc.? I'd like to know what it is exactly that you're driving at.

MR. SHAY: Of what use it would be? Okay. There are the attorney generals of at least four states that I'm aware of. Texas being one of them, have come to a conclusion, rightly or wrongly, four states attorney generals have come to the conclusion that the insurance industry has withheld service, certain insured sectors not based on a need to withhold it, but in a manner to create a crisis. We don't know that because the way the insurance industry reports, and I'm not an insurance professional, my understanding is the way the insurance industry

reports is that you can't tell in this State whether to insure day care centers as a bad risk or not because insurance industries are not required to report that they've taken in "X" amount of money from day care centers and they have paid "X" amount of money out in claims.

SENATOR LESNIAK: I think the problem is the insurance industry can't tell.

MR. SHAY: I think that's correct. Now we don't know if the crisis, because it certainly warrants immediate attention when day care centers can't operate due to a lack of availability of liability insurance-- But we can't tell if that lack of availability, Senator, is based on more money going out than coming in or based on the fact that it's a wonderful media attention getting device. Now I'm not going to make any charges. I'm just saying we have insufficient data to come to that conclusion.

SENATOR LESNIAK: Or over reserves--

SENATOR CARDINALE: Now, hold on. I'd like to research this with you.

SENATOR LESNIAK: Or over reserves or inadequate reserves.

MR. SHAY: Yes.

SENATOR CARDINALE: I'd just like to go into this point a little bit with you. I seem to get the feeling that you go beyond just the media in your conclusion because it isn't just day care centers and it isn't just birthing centers. It isn't just-- It goes through a whole area. Bars can't get insurance; lots of restaurants can't get insurance -- liquor liability insurance at all today in New Jersey, not for any price. Is it your position that situations such as that are simply a conspiracy kind of thing, or that you suspect it's a conspiracy kind of thing that these companies have withdrawn totally from that particular market, even though they were getting very, very high premiums from some of those before they withdrew? Do you think that they're making a business decision?

MR. SHAY: I think that we lack sufficient data to draw

a conclusion on it. You're asking my what my opinion is. My opinion on that is probaoly mixed. In terms of tavern owners, I mean we all know what recent court decisions have been in that regard and if I was an insurer of a tavern I'd be scared to death myself. Intuitively I suspect that's correct. Whether that's also correct, my intuition does not tell me about day care centers.

SENATOR LESNIAK: Factually, though, I don't think that's correct. I don't think there have been any recent, recent decisions on tavern owners' liability that have expanded their liability. There may not be-- That may be the perception, but--

MR. SHAY: Certainly was my perception.

SENATOR LESNIAK: Okay. I don't think that's the case. That may be a better--

SENATOR CARDINALE: Perhaps you had--

SENATOR LESNIAK: Maybe--

SENATOR CARDINALE: Of why they're not writing it at all.

SENATOR LESNIAK: Well, you didn't ask it. But I think this testimony is clear. What you're saying is you can't make that judgment unless you have the information and we don't have the ability to get that information at the present.

MR. SHAY: That's correct, Mr. Chairman.

SENATOR CARDINALE: If you had the information--

MR. SHAY: Yes, Senator.

SENATOR CARDINALE: And you found out that at "X" premium per unit of whatever alcoholic beverages would be served, it might be a good business decision for an insurer to continue writing that. What would you suggest we, as a Legislature, do with that information if we have it.

MR. SHAY: If that's the business decision I suspect you wouldn't have to do anything. It would be written. It would be available, maybe affordable. But I don't think--

SENATOR CARDINALE: I didn't say it was a business decision. I'm saying if we could come to a conclusion as a

Legislative body after looking at these numbers which probably we can't get for 100 years.

MR. SHAY: Yes.

SENATOR CARDINALE: But suppose we could and we made a determination that gee, if they just raised the price another 40% it would be a profitable business for an insurer to be in.

MR. SHAY: Or even if they didn't have--

SENATOR CARDINALE: Are you suggesting that we would then require them to issue the policies at that 40% higher figure?

SENATOR LESNIAK: No, no, no. What he's saying is we would impanel a grand jury at that point.

MR. SHAY: It certainly would be one alternative. Senator, you know, I think you're starting from a false premise. I don't think it would take you 100 years to get it. You require right now a lot of data collection that industry and labor unions and coalitions and not-for-profit organizations comply with and comply with willingly. I don't expect the insurance industry to be any different. To get back to your point about what would you--

SENATOR CARDINALE: No, no, no. I understand what you're going to say because we've heard it all before, but I'd like to hear how you'd approach one other thing that we hear. And that is that despite the fact that they might be making money, an insurance company will pull out of a particular line of business, despite the fact that they have not experienced losses, that it's been profitable underwriting in that line of business, because they cannot predict the risk for next year. So they're going to pull out of the business because the risk is changing and the don't wish to-- And let me give you an example of what I mean so that you can answer the question adequately. The Westwood Board of Education had an $800 premium last year for board members liability, $2 million limit. That's an actual. Their premium this year for $1 million limit, which was all they could get, was $9500. Now, their-- That's dead true. It's in

my district. The insurance company was in that case, I believe, making a decision that they didn't want the business. It was not that they needed $9500. They didn't want the business and the first decision that the board made was to throw out the policy, not renew it, but then they decided the needed a board and nobody wanted to serve on the board if they couldn't have the insurance, so they paid the premium. Now, the justification by the company for not wanting the business, and that's what that means when they come with that kind of a premium, is that they don't know what the risk is going to be because there are new theories that are being advanced with respect to certain kinds of suits that are being brought against boards of education. And they did, if you eliminated certain of those new theories, they did offer a reasonable premium which the board didn't want, but that's all beside the point.

Now, here's a company saying I don't want the business really at almost any price except one which is absolutely -- if you were I, if we were private individuals, would have to consider unaffordable. The Board of Education has taxing authority. It's not unaffordable to them, but here is this situation. Why does a company do that except that there's a very real problem that they're dealing with? When I hear from you and from the fellow who I was rude to a little earlier, I feel that you're not recognizing that aspect of the problem, that there can be a real decision made by businesspeople that I don't want this business because there's just too many problems involved with it. And I don't want it. It's too risky even as an insurance company; that's their business is taking risk; I just don't want the risk, and they pull out. I think that's a very logical explanation. I don't think you have to look for conspiracies. I think you just have to look at what's been happening. And if I were in the business of manufacturing -- thank God, I'm not -- in the business of manufacturing anything, but I couldn't tell what it was going to cost me, I think I'd go out of that business if I was producing any kind of product.

Maybe I've even done that with the little bit of dental business that I was in. I couldn't tell what my cost was going to be next year, what my income was going to be next year in certain aspects and I got out of it. But that's another question.

Why does your organization, certain groups of people not recognize that this is a very real business problem?

MR. SHAY: Senator, the question is why don't we recognize it as a very serious business problem, that's the question. The question (sic) is we lack sufficient information. There is not a data base out there that says I don't know if the reason that the insurance industry came up with a $9500 figure, to that school board that you just articulated, because it wanted the media attention associated with it or because they were very concerned about these new legal theories. I would want to--

SENATOR CARDINALE: There was no media. This is as much attention as that darn thing has ever gotten. That's specious. There is no media attention.

MR. SHAY: Certainly impacted upon a very important legislator, you. Now--

SENATOR CARDINALE: Only because the Board President happened to call me. And he only called me after they did the whole thing because he was incensed with it.

MR. SHAY: Thank God he did.

SENATOR CARDINALE: He didn't even call me to try to do anything.

MR. SHAY: But that particular scenario has been enacted upon throughout this State and throughout the country. You know, I read the newspapers at least an average amount of time and have seen that time and time again. I can't make the charge. I can only make the charge that I lack sufficient information to make a decision. I would want to know -- and I'm not a businessman -- but I do know that the quality of my negotiations that I take part in, the quality of an arbitration that I take part in or a board case I take part in, the product of that endeavor is directly related to my preparation and my

ability to gather sufficient information.

In the particular case you just cited I would want to know from the insurance company what new legal theories that you're talking about, where do they stem from, where have they been enacted, and how has it impacted upon a board member in the past, either in New Jersey or in another state. I would want you to justify to me your concern. If you can't, then that's something that you have to deal with as a legislator. If they can't justify that concern, then we have to deal with that. I suspect that if they withdraw from certain segments, and there is not sufficient data, or the data suggests that they should not be withdrawing, then given the entrepreneurial spirit of this State and this company, somebody will fill that vacuum. In the meantime we may have to come up with an interim measure to fill that vacuum, but it will be filled.

SENATOR CARDINALE: You see the third from the last statement that you made, that were this entrepreneurial filling of the vacuum, see, that I happen to agree with. But I don't see homeowners insurance, for instance-- If someone was trying to have an impact such as you're suggesting they're trying to have, I would think that the insurance companies would conspire, if they want to conspire on something, they could conspire on homeowners insurance. They haven't got--

MR. SHAY: I'm glad you mentioned it. I've got a story on homeowners insurance from one of our members, if you'd like to hear it.

SENATOR CARDINALE: I see that companies are reducing the rates on homeowners insurance today, some of them. I've seen those kinds of reports. And--

SENATOR LESNIAK: Anticipation of the Cardinale host liability law--

SENATOR CARDINALE: Cardinale/Lesniak host liability, which is being played ping pong with. That's another story. But no. You see, there are very real things and you've said -- enumerated them, certain specific kinds of things, and they're

not just high profile things. It's obvious that there are problems that insurers are seeing with certain lines of business and it is in those lines of business that they are either pulling out or making the price ridiculous, absolutely and utterly and completely ridiculous and illogical.

MR. SHAY: Senator, then I would want to know--

SENATOR CARDINALE: No businessperson does that without reason.

MR. SHAY: I would want to know why that same perception was not that there -- and again I'm not making a charge -- but I would want to know why that same perception was not there when the average interest rate was 18%. Why was it there now when it's dropped 10 percentage points or more? I would want to know that because I know, and I'm a layman, but I know of no great expansion of legal rights or legal theory that has taken place. I do know that interest rates have dropped 10 points. If the principle is, in fact, the principle, the principle was there at 18% as it is now at 8% interest.

SENATOR CARDINALE: You don't see an expansion of liability in the courts over a period of time?

MR. SHAY: In the past two years? No, sir. I don't.

SENATOR CARDINALE: Hold on. Insurance doesn't work on year one to year two to year three. Insurance works on the basis of a many year trend. You don't see a trend over the past many years of an expansion of liability as a principle of law?

MR. SHAY: I would want to-- I can't answer that question. But I think the more important question to ask is I would want to look at the financials of the insurance companies to find out if they've been adversely affected by any expansion if expansion has occurred. Because if an expansion--

SENATOR CARDINALE: I've opened--

MR. SHAY: Because if expansion has occurred and they've not been affected, it doesn't matter.

SENATOR CARDINALE: Have the--

MR. SHAY: Is that correct? Uh, I'm sorry.

SENATOR CARDINALE: The end financial results of the insurance companies, have you not been able to see those?

SENATOR LESNIAK: Go ahead. Beat him up, go ahead.

SENATOR CARDINALE: Oh, I don't think he's beating me.

MR. SHAY: I'm certainly not trying to, Senator. Just trying to answer your questions.

SENATOR CARDINALE: Have those reports, the financial reports, the overall profitabilities of insurance companies, have you seen those?

MR. SHAY: Yes, I quote them in my prepared testimony from "Bests" and from the Insurance Information Institute. See on the bottom of page three, last paragraph, "The same companies that according to 'Bests' of December '85 had an investment income of $19.7 billion in 1985, the same companies that according to the Insurance Information Institute realized a capital gain of $5.3 billion last year"--

SENATOR CARDINALE: Okay, so you agree that they're still profitable.

SENATOR LESNIAK: Wait a minute. But those numbers in and of themselves don't mean anything unless you relate them to return on equity and is not the bottom line return on equity?

MR. SHAY: Absolutely, yes, it is. And we don't have sufficient detailed information to get at that.

SENATOR CARDINALE: No, but I do think you have an awful lot of information and some of it has been submitted to this Committee and other committees. The question is that there is a steady upward trend in profitability of insurance companies, and that's not the problem. And the insurance companies haven't maintained that. I hear people, certain organizations always pointing out the insurance companies are making all this money as if they discovered it. Those are the reports by the insurance companies. Those are not the reports from-- You're quoting from their publications. And they've given us that information, too. But that's not the question. The question is with a continuous, regardless of interest rates, upward movement in total gross

dollar profits by the insurance industry, their pulling out of certain lines and the other effect is the effect on the consumer, that I thought you were supposedly working for here, and I think we're ultimately supposedly working for. The effect on the consumer is that in order to continue to fund those profits the premiums have gotten to the point where they're hardly affordable for most people, and even people who don't pay those premiums directly are paying for the products that those premiums are an essential component in terms of the cost.

SENATOR LESNIAK: Senator Cardinale, you've learned some economics over the last year.

SENATOR CARDINALE: I knew a little economics, Senator, probably before you got your law degree. But I don't understand why there isn't recognition--

MR. SHAY: I explained that to you quite simply, because we don't have sufficient information to come to that realization that that is the appropriate realization. In order to come to that realization you have to know if that $9500 premium bears any resemblance to a cost/risk analysis. You have gross figures contained in the reports.

SENATOR CARDINALE: Let me change that into a hypothetical situation.

MR. SHAY: Okay. Can I finish my answer, though, before you do that?

SENATOR CARDINALE: I know what your answer is. You said it before.

MR. SHAY: Okay.

SENATOR CARDINALE: But you're not answering the same question that I'm asking.

MR. SHAY: I thought-- I'm trying. I thought I was.

SENATOR CARDINALE: That's my problem. You're not answering the same question that I'm asking.

MR. SHAY: Perhaps I misunderstood the question.

SENATOR CARDINALE: My question is that as a practical matter the $9500 could just as well have been, "We won't issue

the policy." The company was saying, "I don't want the business."

MR. SHAY: Then why didn't they say that? Why did they say, "If you pay me $9500 I'll take it?" Why didn't they just say, "I won't take it at any price?"

SENATOR CARDINALE: I don't know.

MR. SHAY: That's my point.

SENATOR CARDINALE: But that is sometimes a way in business, all kinds of business -- you said you were not a businessman. I've been a businessman in many different areas. And one way I would reject business is figure out what I should charge and put a price 10 times as much on it. If a patient came into my office that I didn't want to see I might say to them, "I just don't want to see you." I would be more likely to just say to that patient, "Look, maybe you should go see someone else, but if you want me to handle it, it will be more expensive than if you go to see someone else, so why don't you go see someone else?" And if they really pressed me I might put a number on "more expensive" that was totally and completely irrational, and I knew that, in effect, they wouldn't have it done. And if they did, you know, then I wouldn't know what I would do next.

MR. SHAY: You wouldn't have any choice, Senator.

SENATOR LESNIAK: Senator Cardinale-- Oh, I'm sorry.

SENATOR CARDINALE: But that's what they've done. Don't you see? They've said in the face of what you say is absolutely irrational and unreasonable kind of situation they've said, "We don't want the business."

MR. SHAY: No, Senator. I didn't say that. I said I lack sufficient information to come to that discernment.

SENATOR CARDINALE: Isn't it sufficient information to know that someone in business for a profit motive that says, "I don't want the business."

MR. SHAY: If they're going to make-- One hypothetical would be if they're going to make a short-term sacrifice for a long-term gain, then I think that's a very good

business decision. Or at least has the properties of a very good business decision.

SENATOR CARDINALE: I'd like to know go and explore that theory with you, with the indulgence of the Chairman because this is really the issue that we are going to have to face. Mr. Chairman, it is the issue we're going to have to face.

Do you think that these clever businesspeople who have conspired without any overt evidence that they have conspired--

MR. SHAY: That's a charge I have not made.

SENATOR CARDINALE: There are people who believe that, and there are people who are making those kinds of charges, and there are people who are asking the Attorney General to investigate.

MR. SHAY: Yes.

SENATOR LESNIAK: Including the Senate which approved the resolution.

SENATOR CARDINALE: We asked them to go investigate. We didn't say they're conspiring. We asked them to go investigate.

SENATOR LESNIAK: No, but asked them to investigate.

SENATOR CARDINALE: We asked them to investigate. We're just like him, we said we want the information.

MR. SHAY: We agree.

SENATOR CARDINALE: You say long-term benefit, and I think that you mean if we change the tort laws and there is decreased payout on the part of the insurance companies, then their profits are going to go up. You don't think that we're going to have entrepreneurs within the insurance business cutting the premium to get a bigger market share?

MR. SHAY: Senator, it's my understanding as a lay person that the insurance industry is one of two industries in this nation that is exempted from antitrust legislation.

SENATOR CARDINALE: I'm not talking about antitrust. I'm talking about the entrepreneurial spirit.

SENATOR LESNIAK: In certain aspects they are allowed

APPENDIX

to file rates together, which if they were a gasoline company they would go to jail for.

MR. SHAY: And exchange information, exchange actuarial information.

SENATOR LESNIAK: Right. They aren't exempt from colluding to set rates, for instance, other than for their rate filing purposes.

SENATOR CARDINALE: Unless we have laws which prevent them from lowering their rates, which--

MR. SHAY: No.

SENATOR CARDINALE: I have no assurance.

MR. SHAY: I do know that we won't know what impact it has on premiums unless we get the kind of detailed disclosure that we're looking for, and I don't understand why we don't want that kind of detailed disclosure we ask for from practically every other business segment and labor segment doing business in this State.

SENATOR CARDINALE: I sponsored the bill to get them as detailed exposure.

MR. SHAY: I would even go beyond what you asked for, Senator, in your bill.

SENATOR LESNIAK: Aren't we going far afield here, Senator Cardinale?

SENATOR CARDINALE: Well, I think now that I agree with you and we are, and I don't think there's any point to pursuing it any further because--

SENATOR LESNIAK: Okay. Any further comment?

MR. SHAY: One last comment. Since we don't know what the impact will be on premiums, the industry will not say what its belief is upon the impact. We know that the industry in conjunction with various departments doing studies on it cannot come to any conclusions from their own experts. We don't know what the impact will be on affordability, and we don't know what the impact will be on availability, but we certainly can conclusively come to a realization what the impact will be on

individuals. I just would move one more time to try to come up with as much detailed information to try to come up with some kind of probable range of what the impact will be on affordability and availability before we impact on the individual.

SENATOR LESNIAK: Thank you very much.

MR. SHAY: Thank you very much for your courtesy.

SENATOR LESNIAK: Thank you very much. Hearing is concluded. Thank you for sticking it out. Thank you, Senator Cardinale.

(HEARING CONCLUDED)

TESTIMONY OF STATE INSURANCE COMMISSIONER KENNETH D. MERIN

BEFORE

SENATE JUDICIARY AND LABOR, INDUSTRY AND PROFESSIONS COMMITTEES

July 30, 1986

SENATE JUDICIARY AND LABOR, INDUSTRY

AND PROFESSIONS COMMITTEES

JULY 30, 1986

Senators O'Connor and Lesniak and committee members:

Thank you for inviting me to speak today. I have been asked to discuss the background and causes of the commercial liability crisis.

Those causes are many and varied.

When I first became Insurance Commissioner two years ago I was appalled at the quality of insurance regulation in New Jersey. To my dismay, I later learned that the situation in New Jersey was comparable to that which exists throughout the country. Our department is in the midst of year two of an anticipated six year effort of getting the type of computer equipment that will enable us to do a better job of regulating the industry. The National Association of Insurance Commissioners is beginning to move towards a more comprehensive system for examining the financial viability of the insurance industry. This type of regulatory effort is long overdue, since more effective regulation and greater access to information might have been instrumental in avoiding, or at least ameliorating the effects of, the current crisis.

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The insurance industry is, in my opinion, most responsible for the current crisis. The industry-based causes are basically eight in number:

1. The price war among major carriers from 1980 to 1984 fueled by the unprecedented rise in interest rates at the outset of that period.

2. The fear among larger companies of loss of market share which would be the result of being the first to back off from the price war.

3. The industry did not react properly to the trend towards higher liability protection costs (court awards).

4. Smaller companies continued the price war in order to generate cash to pay claims on previously written, underpriced policies.

5. Ineffective State regulatory schemes limiting the ability of State regulators across the country to direct insurance companies to raise rates and force consumers to pay higher prices.

6. International economic impact of currency exchange rates on alien reinsurers who must pay U.S. claims in U.S. currency.

7. Dislocation in the reinsurance market.

8. Abandonment of internal management controls on the underwriting process, lack of actuarially based pricing, and failure to incorporate risk prevention measures into the risk acceptance process.

The industry has lived through many up cycles and down cycles and will live through many more, long after we have left the insurance scene. But the excessive competition of the last few years far exceeds anything that the industry had previously experienced. Regulators and members of the industry must work together to take those steps that will lead to some containment of the business cycle.

This cycle itself is absolutely frustrating to consumers and non-insurance professionals. When the industry is in a crisis stage of the cycle, it sees huge underwriting losses, destructive price competition, and the risk of major insolvencies. To the consumer, however, this is not a crisis - just a buyers market, characterized by full availability and inexpensive rates.

As the industry comes out of the crisis stage it enters the up-turn stage in the cycle. This stage is seen by the industry as encompassing increased revenues, higher combined ratios and a lower average risk. But this upturn to the insurance industry is seen as the crisis stage for the

4x

consumer, where the insurance market is characterized by lack of availability of some lines and rapid price increases in all lines.

While it's simple to describe the cycle in a general fashion, it is difficult for the consumers to understand why it has to happen.

Nor can consumers readily understand industry accounting, which for the first time is being closely scrutinized by the public.

For example, the property and casualty industry claimed an underwriting loss in 1985 of about $25 billion. That figure was arrived at by subtracting claims and expenses from premiums. However, in 1985 the property and casualty companies realized over $19 billion from their investments. Thus, the operating loss was $5.5 billion. After the industry realized profits from investments that had been sold, and accounted for tax refunds, the balance sheet for 1985 showed a $1.57 billion profit, not a $25 billion or even a $5 billion loss. While the underwriting statistics may be accurate, they are insufficient, standing alone, to accurately describe profitability. In using them to explain to the public the gravity of the situation, the industry has exposed itself to criticism for attempting to mislead the public.

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Now I am not suggesting that all is well in the insurance industry because it is not. The number of insurance companies that are failing, the poor return on net worth in the recent past and the fact that companies who are supposed to be in the business of writing insurance aren't doing so, clearly indicate that problems exist. Underwriting losses, operating losses, combined ratios and insolvencies all reached record levels in 1984.

Also, the loss experience of self-insureds mirrors the loss pattern of the companies, and is inconsistent with allegations that the current crisis is a complete fabrication by the industry. A casebook example of one self-insured, New York City, illustrates this point. Numerous sources, including the Cuomo Commission Report document the increase in the dollar value of the average personal injury settlement for the City.

One insolvency can have a devastating impact on market conditions and policyholders. State Insurance Commissioners traditionally view as one of their most important functions the avoidance of insolvencies. Yet, try as we might, New Jersey policyholders have experienced the rehabilitations and/or insolvencies of 16 out-of-state companies in the past two years. Countrywide, 501 companies, including several in New Jersey, are already experiencing financial troubles in 1986.

6X

To me, one of the most interesting aspects of the insurance side of the crisis is in the reinsurance and surplus lines market.

Property-casualty insurers are finding that some of their reinsurance is uncollectible because of financial troubles within the reinsurance industry. Over the past two years, 20 reinsurers have failed and another 70 have withdrawn from the U.S. market. The failure of the Mission Insurance Group in California has severely impacted certain companies.

Most Americans who have heard of Lloyds of London know about it because of a celebrity policy they may have written. Bud Abbott and Lou Costello once took out a $100,000 policy with Lloyds that stipulated payment if anyone in their audience died of laughter.

People are not laughing at Lloyds' celebrity policies anymore.

Lloyds has been shocked in recent years by a succession of losses and scandals unheard of in the history of that syndicate. For example, Lloyds was defrauded of more than $1 million in losses on slum property in the U.S. Lloyds was hurt when a warehouse in the Netherlands burned down destroying $14 million worth of butter that Lloyds had not realized was in one location. The sinking of the

supertanker Amoco Cadiz off the coast of Brittany led to claims of more than $2 billion. It was also discovered that some of the leading members of the Lloyds' syndicate had misappropriated money, and had reinsured risks with non-Lloyds companies that were clearly undercapitalized. All of this has led, in the past few years, to a restructuring of the Lloyds' syndicate. New operational and disclosure rules for Lloyds brokers and underwriters have been instituted. Clearly, all of the troubles that Lloyds has had cannot be divorced from the situation with which we are confronted in the U.S. Almost half of all of Lloyds' business is done here and in certain specialized areas, some 2/3 of particular lines in the U.S. are dominated by Lloyds. With the 300 year old Lloyds syndicate reeling from such events, it is no wonder that our market has been impacted.

What changes in the insurance regulatory scheme should be made to minimize the effects of the insurance cycle? The report on liability insurance issued by a special commission appointed by Governor Cuomo found six in number:

1. Introduction of flex rating. New York has a "file and use" system for commercial lines and a "prior approval" system for personal lines (auto & homeowners).

2. Strict regulation of notice of cancellation

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and non-renewal. The Commission recommends that New York enact legislation similar to the cancellation regulations enacted in New Jersey.

3. Establishment of an insurance consumer advocate funded by an assessment on the total revenues from commercial insurance lines of insurers. Our Public Advocate currently serves that function.

4. Strengthening the Insurance Department by increasing the staffing and equipment needs of the Department. New York's Insurance Department is one of the largest in the country and is already more advanced than New Jersey's Insurance Department. We are committed to improving the Department and I personally want to thank the Governor and Legislature, particularly Senator Weiss and Assemblyman Villane, Chairs of the Appropriation Committees, for their help. Through these efforts, the Department's budget has increased from $6.1 million in FY'83 to $10.7 million in FY'87.

5. Increasing the availability of public entity liability insurance by giving the Governor the authority to create a market where none exists. Suggestions include strengthening the market assistance program; creation (by legislation) of

the authority for the Governor to develop a reciprocal insurance association for local governmental entities; and creation of stand-by authority in the Superintendent of Insurance to implement a joint underwriting association to compel all commercial casualty insurers to write public entity liability coverage in New York. The Commission also recommends creation of the authority to permit the State Insurance Fund, which now provides workers' compensation and disability coverage, to enter either the public entity market or a broader commercial market acting as a primary insurer or re-insurer. As you know, a MAP was instituted in New Jersey last month.

6. Mandating that the Superintendent of Insurance in New York conduct a study as to the financial effect on insureds if insurers were to treat New York public entities as a separate class for the purpose of setting rates.

All of the above recommendations, if implemented prior to the current situation, would have enabled regulators to deal more effectively with the periodic changes in the insurance marketplace, especially as they affect public entities. None of them, however, are designed to have an impact on the underlying costs of providing insurance protection. Completely separate and distinct remedies,

lumped together under the rubric of "tort reform", have been offered to address the cost problem.

You are all aware of the interest in tort reform that is sweeping the country.

The Cuomo Commission Report found that the bulk of the surge in liability costs was attributable to noneconomic damages (pain and suffering, mental anguish, etc.) It found that this growth was not solely a function of the presence or absence of insurance, but rather a reflection of the laws and mores of society.

Regarding civil litigation, the backlog in the court system is more attributable to criminal and civil rights cases than to personal injury trials. Nevertheless, the New York Commission decided that changes in tort laws as a means of restraining the increase in the cost of liability protection are necessary for three reasons:

First, the central source of the cost surge is the increases in the incidence of large to very large claims. Although these claims total less than 10% of all claims, even a small expansion in this area would spur cost acceleration.

Second, there is a tendency to raise the number of dollars that Americans feel are necessary to compensate a given example of intangible harm. When insurance is

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available, a jury's desire to provide the most assistance possible is great.

Third, many large claims involve significantly increased transaction costs. Resources to be drawn upon include doctors, professors, jury behavior researchers, accountants, design engineers, and others. The Commission estimated that these overhead costs could consume as much as two-thirds of the money expended to handle certain types of cases involving masses of claimants. In fact, A.M. Best found that the costs of claims increased 63% over five years, while the cost of living increased only 38% and premiums did not increase at all.

The Cuomo Commission reinforced this view.

> "It must be added that these factors will be reinforced unless there is a slowing in the succession of new legal doctrines and reinterpretations of insurance policy language that have the effect of expanding civil liability. This is particularly true where commercial and public entities are concerned.
>
> All in all, in our judgment, the evidence available strongly suggests that we haven't yet seen its peak. When the City of New York projects that the outstanding claims against it that were filed before June 30, 1985 have a projected payout value of $1.5 billion -- or nearly 13 times the City's current annual payout -- it is difficult to see anything but higher costs ahead unless the legal environment is changed."

Those who oppose reform of our tort law system insist that the insurance industry does not have enough data to support the increased premiums of the last few years, that

the focus of reform should be on the industry, not on the judiciary. The industry, however, is struggling to keep up with court opinions that constantly expand the nature of the insured risk. (See comments of Cuomo Commission at Exhibit A.) In the light of cases such as Jackson Township, past claims data is of more limited value in the forecasting of rates and premiums. While Jackson Township and some other cases that broadened the traditional contract of insurance have been reduced or overturned by the Appellate Division, others have not. For example, the Jackson Township case drastically expanded the meaning of the term "occurrence" by defining each day of pollution seepage as a separate "occurrence". Thus, the occurrence limits contained in the policy were rendered meaningless, and the failure of the insurer to insert an aggregate policy limit resulted in a huge liability award. Although the amount awarded was reduced on appeal for other reasons, the principle enunciated in the decision remains, forever changing insurance contract law.

In another case, the New Jersey Supreme Court in Beshada has determined that strict liability encompasses liability for product defects undiscoverable at the time of manufacture. Although the effect of that case has been limited by later decisions, it illustrates the significant impact that the court system can have on insurance costs. If a company cannot determine the potential danger of products it manufacturers, how can an insurance company set the amount

of coverage necessary to pay losses associated with those products?

Tort reform opponents also claim that tort liability provides a system of justice which holds the wrongdoer responsible for his actions. But this argument is unrealistic because plaintiffs are not generally compensated by the perpetrator of the incident but rather by the insurance system itself. In other words, all insureds, not just the defendant, are held responsible.

The tort system, as it currently exists, provides haphazard justice to the plaintiff and penalizes society as much as it does the defendant in the individual action. When a municipality or governmental entity is held liable, tax rates go up. When corporations buy more and more insurance, products become either more expensive or less available.

The system is arbitrary in that similar victims often receive totally dissimilar results based upon everything from the talents of the lawyer, the composition of the jury and the location of the lawsuit.

Various studies have found that urbanization is one of the greatest indicators of both frequency and severity of claims. Given that we live in the most urban state in the country there is no wonder why the tort crisis hit New Jersey sooner and harder than it did the rest of the country.

The tort system is expensive to operate in comparison to other compensation systems. It has been estimated that products liability, asbestos, and medical malpractice plaintiffs only receive approximately 30% of the liability insurance premium dollar. I have attached to my testimony a list of tort reform actions taken by various states. The New York Commission also produced a comprehensive discussion of these issues.

I have attempted to highlight the many and varied factors causing the national insurance crisis. Let me now bring this discussion home to New Jersey.

Last fall, Governor Kean issued an emergency regulation - the first of its kind in the country. Insurance companies were terminating coverages at an alarming rate in almost all insurance lines. That regulation was adopted as a stopgap measure designed to preserve existing insurance coverage.

The regulation has been recently modified to eliminate personal and surplus lines from its scope. In recognition of the reinsurance availability problems mentioned above; insurers are not obligated to renew existing policies with similar coverage. Also, prior approval of company underwriting guidelines has been replaced with concurrent or subsequent approval. Despite these changes,

the New Jersey regulation is still the toughest such regulation in the country.

Significantly, the recent regulation permits the formation of a MAP. Under a MAP concept, companies agree to return to a market from which they had begun to retreat and accept on a formula basis good risks otherwise unable to obtain liability coverage. Right now, the MAP is authorized to handle municipal liability insurance, insurance for day care centers and liquor liability insurance. It began operations on June 3, 1986 and takes six to seven weeks to place coverage since its initial efforts are toward preserving coverage with the current carrier. Recently, a hotline was added to assist agents in placing other lines not now covered by the MAP.

I would like to briefly address two other issues before concluding my testimony.

We recognize that conspiracy allegations have arisen questioning whether industry losses are contrived to foster tort reform. The State Public Advocate has asked the Attorney General to examine this issue, and I intend for my Department to contribute its resources to this effort. I must point out, however, that the federal government has not relinquished all antitrust regulatory oversight to the states. In fact, the Clayton and Sherman Anti-Trust Acts continue to prohibit any acts of, or agreements to, boycott,

coerce or intimidate. Two United States Supreme Court cases have recently upheld the right of the federal government to examine these areas.

New York's Cuomo Commission was asked to study this issue and reported as follows:

> "We have found no evidence of any conspiracy, nor do the size and competitive nature of the property-casualty insurance market lend themselves to a plausible threat of effective conspiracy. Moreover, if there were any such conspiracy, one would expect it to be most determined to hide financial improvement during this period, when legislative consideration of tort reform is at is height and whatever pressure could be exerted would presumably be most productive. Yet, it is at precisely this juncture that reports of financial improvement are beginning to appear.
>
> Our judgment in this matter is further reinforced by the fact that, though purveyors of the conspiracy theory usually identify overreserving as the principal technique for distorting results, the opinions of those engaged in close regulatory scrutiny of the industry, particularly here in New York, are uniformly to the effect that there is a serious problem of inadequate reserves against losses, not an excess of reserves. We cannot totally rule out the possibility that the members of a closely regulated industry would risk severe penalties by misstating their financial condition to regulators, auditors and taxing authorities, but in the absence of any evidence that such massive violations have occurred, we regard the probability that they have as extremely low."

It is difficult to argue with the logic of the Cuomo Commission on this matter. I promise that the Insurance Department will vigorously assist in this investigation, but urge you not to delay other reforms pending the result of that review.

Is there a role for the federal government in the

regulation of insurance? I think so. The federal government can be particularly helpful in establishing and collecting necessary data on a uniform basis. In addition, the federal government can assist in cost avoidance in various lines of insurance by taking action individual states cannot. For example, no-fault automobile insurance costs could be lowered by the mandatory inclusion of air bags in passenger vehicles, as well as a required upgrading of crashworthiness standards. There is also a federal role in policing interstate crime (stolen cars, etc.)

But, should the federal government assume the entire regulation of insurance? I think not. Every state insurance market is different, as demonstrated by the many and varied state responses to the insurance crisis. In addition, when the Congress was initially discussing whether the states should retain the power to tax and otherwise regulate the insurance industry, it coupled "regulation" with "taxation". According to a 1979 General Accounting Office document, the House of Representatives Report issued at the time the McCarran - Ferguson Act was passed noted that the South-Eastern Underwriters decision by the Supreme Court which ruled insurance was interstate commerce and, therefore, subject to federal regulation also casts doubt on the state's power to tax insurance companies. If we were to relinquish state control, we may also be asked to relinquish the tax monies provided to the states through insurance regulation. I don't think that New Jersey is ready to transfer to the

federal government the $150.5 million in insurance taxes and fees it receives annually.

What is to be done about this crisis which impacted every line of commercial insurance? No single answer is acceptable. Tort reform alone is not the answer; it only affects the level of costs. It will do nothing to prevent a return to lack of availability and/or the cycle swings which greatly affect the market. Instead, reforms are needed to temper the cycle and foster the kinds of regulatory mechanisms that can detect industry problems at the embryonic stage.

Specifically,in addition to tort reform, I am more inclined to opt for a combination of some of the elements proposed in the Deregulation Report issued by the New Jersey Department of Insurance in April, 1986, with the flexibility afforded by the flex rating system similar to that recently proposed to Governor Cuomo. This combination would give New Jersey the ability to better monitor the adequacy or excessiveness of rates, while providing the Department with the power to act in the public interest.

In addition, I agree with the recommendation of the National Association of Insurance Commissioners for all states to strive for legislation granting Insurance Commissioners standby authority to establish joint underwriting associations for unavailable lines. Alternate

compensation systems for certain lines of insurance is an issue that I will also take under review.

In sum, I wish to reiterate that, just as there is no single cause to our insurance crisis, there also is no single solution. The causes and solutions are varied and complex. I stand ready to work with you to fashion legislation to meet the insurance needs of New Jersey consumers.

Thank you for allowing me to share some of my thoughts with you today.

The central issue in today's debate, however, revolves not around insurers' views but around the presence or absence of decisive empirical evidence. What is the established quantitative linkage between tort law changes, on the one hand, and the availability and affordability of liability insurance on the other? The short answer is that currently there is no reliable research that establishes a precise quantitative linkage between modifications in the civil justice system and the effects on insurance markets. There is substantial evidence to the effect that such a linkage exists, and the directions in which tort law changes move insurance rates over time, but the quantitative dimensions of that relationship have not been established.

The reasons for the absence of quantitative proof are treated at length in the text of this Volume. Basically, they are three. First, there is simply not a great deal of general tort reform experience to study. Prior to this year, few states had enacted broad tort reform measures. Earlier generations of tort reform tended to be limited to highly specialized classes of defendants, usually health care providers, with such distinctive characteristics that generalizations from their experience to broader classes of defendants have been properly regarded as

dangerous. Second, the limited empirical research that has been performed has focused on the cost savings and other direct financial effects of tort reform, not on the translation of those savings into insurance pricing and coverage. Finally, empirical research in this area is inordinately time-consuming, expensive and complex. Consequently, there are few professionals doing dispassionate work in this highly contentious area.

Perhaps even more important, it is illusory to believe that the capacity to predict the precise effects of tort law change on insurance price or supply will exist in the forseeable future. Fundamentally, this reflects the fact that insurers are engaged in two complex businesses -- underwriting and investment -- and an insurer's marketplace behavior will be driven by the net profitability of those two businesses at a given point in time. Those two businesses are affected by the widest imaginable range of economic and financial forces, and the professional research community today is very far from being able to assemble a model that would credibly reflect all those variables. Even if underwriting existed in an isolated universe, price and supply would still be affected by many forces beyond tort law, including other underwriting costs (e.g., defense costs), demand for coverage, underwriting capacity and myriad other influences. This Volume provides a summary description of the analytic and forecasting instruments that would be required to quantitatively link tort law change with insurance price and supply effects. The interested reader is referred to that discussion for a more detailed treatment. But the relevant conclusion is that any decision to defer action until air-tight, quantitative proof on this issue is available is a guarantee that no action will be taken to ease the liability cost surge for as far ahead as it is now possible to see.

It is critical to distinguish, however, between what we do not and cannot know and what we do know. As reported in these Volumes, there is substantial evidence on the direct financial effects of tort law reform on liability costs. That evidence confirms what we would intuitively believe: that tort law changes which limit defendant liability or limit money damages, or which restrict incentives for plaintiffs or their attorneys to seek higher recoveries, tend to reduce the average compensation paid by defendants. In brief, the case that significant tort law changes can affect the liability costs that insurers and self-insurers bear is established. In the case of some tort law changes enacted with respect to specialized classes of defendants, such as health care providers, this effect has even been quantified.

The nub of the issue is whether empirical proof is needed to sustain the proposition that lower liability cost will translate into lower prices and increased supply for insureds. Because affordability and availability reflect a range of variables extending well beyond tort law, there will not necessarily be a 1:1 relationship between changes in the civil justice system and the insurance marketplace at any particular point in time. But, it is an accepted truth that in highly competitive markets with low barriers to entry changes in the cost base will exert pricing pressure in the same direction. In a stable economic environment, that linkage will be relatively direct. Even in a more volatile environment, changes in underwriting cost will eventually be felt. Over the long haul, the behavior of underwriting costs will heavily influence how much insurance is written and at what average price.

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Outline of Tort Reform Actions in 10 Major States

California

1. joint and several liability

Florida

1. joint and several liability
2. cap on damage awards
3. punitive damages
4. collateral source
5. periodic payments
6. use of alternative dispute resolution
7. medical malpractice

*Rate reduction mandated but stayed by court: 3 month, 40% rate reduction in commercial liability rates during final quarter of 1986.

New York

1. joint and several liability (pending Gov's signature)
2. attorney's fees
3. collateral sources
4. periodic payments of judgments (pending Gov's signature)
5. medical malpractice and professional liability

*Flex rating: replaces open rating system and requires the Ins. Dept. to set ceilings on rates beyond which rates must be prior approved by Dept.

*Cancellation/nonrenewals: permits annual policies only; prohibits midterm cancellation; requires 60 day advance notice if policy is terminated or premium increase exceeds 10%; permits policyholders to obtain loss and claim history.

*JUA: generic JUA established to provide insurance for troubled lines.

Illinois

1. use of alternative dispute resolution
2. punitive damages
3. medical malpractice (trial court held; unconstitutional; on appeal)

Maryland

1. Caps on damage awards

Massachusetts

1. liquor law (dram shop) liability reform

Minnesota

1. cap on damage awards
2. punitive damages
3. collateral source rule changes
4. interest on judgments
5. environmental liability

Texas

1. medical malpractice

*data: State Insurance Board started a closed claim survey beginning November 1985 for 6-month retrospective collection of data.

Washington

1. joint and several liability
2. cap on damage awards
3. attorney's fees
4. periodic payment of judgments
5. liquor law (dram shop) liability reform
6. professional liability

*Rate increase requests refused

Wisconsin

1. medical malpractice
2. liquor law (dram shop) liability reform

Statement
of
Joseph F. Johnston, Jr.*
on

Liability of Corporate Directors

before the

Senate
Labor, Industry and Professions Committee

State of New Jersey

August 26, 1986

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Liability of Corporate Directors -- Recent Developments*

In recent years, the liability of corporate directors has received considerable attention. The principal reason for the rising concern over directors' liability has been the increasing difficulty in obtaining directors and officers ("D&O") liability insurance. Many corporate directors feel that they are not willing to risk their personal assets just to remain on corporate boards. Since the frequency and severity of claims against corporate directors (as well as officers) has been rising, it is understandable that the corporate community as a whole has become concerned.

D&O insurance has been subject to the same pressures as general liability insurance, and has been characterized by similar premium increases and restrictions of coverage over the past two years. But this class of insurance has certain unusual features that deserve separate consideration.

Reasons for D&O Insurance[1]

The demand for D&O insurance has expanded rapidly in recent years. In the mid-1960's, only a few corporations carried D&O insurance for their directors and officers. By 1983, as reported in the Wyatt Report,[2] D&O insurance was carried by 98% of all U.S. corporations listed on the New

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*. Portions of this statement have been excerpted from an article on "Causes and Effects of the Insurance Crisis," to be published by the Southwestern Legal Foundation.

York Stock Exchange. The policy limits carried by most companies also increased substantially.

The basic reason for the growth in demand for insurance covering directors and officers has been the rapid expansion of litigation against corporations and their directors and officers that began in the 1960's and has continued to the present day. There are various explanations for this increase in litigation, including the liberalization of procedural restrictions on class actions, expansive court interpretation of class action remedies, proliferation of damage actions under SEC Rule 10b-5 after Texas Gulf Sulphur[3] and other securities fraud cases, improper payments and other corporate misconduct during the "post-Watergate" era, increased SEC enforcement activity, an increase in corporate takeover attempts (with the inevitable litigation that accompanies such attempts) and an erosion in the protection afforded to directors by the "business judgment" rule.[4] It is also probable that the very existence of D&O insurance has itself stimulated litigation, since plaintiffs' lawyers regard the insurance as another "deep pocket" from which to seek recoveries.

Simultaneously with the litigation explosion of the 1960's, corporate lawyers began to be seriously concerned about the gaps in corporate indemnification. Indeed, the basic reason for the existence of D&O insurance is that corporate indemnification does not protect directors and

officers in certain important respects. For example, under many state statutes, no indemnification can be made in a derivative action with respect to any claim as to which the director or officer shall have been adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation.[5] This is a major gap because virtually all derivative actions against directors and officers allege such conduct. In addition, the extent to which the corporation can indemnify for amounts paid in settlement of derivative actions is doubtful. Further, the appropriate decision-making body (the board, the stockholders or independent legal counsel) may be unable or unwilling to conclude that the director or officer in question has met the required statutory standard of conduct. This may be a particular problem where control of the corporation has changed hands or where the facts as to the individual's conduct are in dispute. Also, of course, the corporation may be insolvent and unable to make indemnification payments.

Finally, the SEC has consistently taken the position that indemnification by a corporation of directors, officers, or controlling persons against liabilities arising under the Securities Act of 1933 (the "1933 Act"), and perhaps other securities laws as well, is against public policy and unenforceable.[6] The SEC's position leaves the directors and officers exposed to the possibility that they cannot be protected by corporate indemnification against a wide variety

of claims under the federal securities laws, including suits for misstatements or omissions in registration statements, proxy statements and other documents, or in connection with mergers, acquisitions, or tender offers.

The D&O Insurance Crisis

The number of lawsuits against directors and officers has increased dramatically in recent years, along with the costs of such litigation. According to the Wyatt Report, in the five years from 1980 to 1984, the frequency of D&O claims rose about 58% and the average claim severity rose about 69%.[7] Average legal defense costs per claim in 1984 were estimated at $461,000 (up by more than 250% since 1974).[8]

Recently, a series of very large settlements in D&O cases has shaken D&O insurers. Last year, for example, the Transunion case in Delaware was settled for $23.5 million, of which the D&O insurers paid $10 million. The Chase Manhattan derivative litigation was settled earlier this year for $32.5 million. D&O carriers have paid many multi-million dollar settlements in recent years, and it is expected that more will follow. Some cases now pending may set world records for D&O insurance payouts. It does not take very long for settlements of this magnitude to eat up premiums previously received. Knowledgeable sources report that D&O underwriters in the years 1981-84 have probably paid out in claims three or four times the amount of premiums collected, and in some

cases even more. These kinds of loss ratios, of course, could not be sustained indefinitely.

Part of the difficulty can also be traced to the cyclical nature of the property/casualty insurance business and to excess capacity in the market during the late 1970's and early 1980's. The cycle was exacerbated by the extremely high interest rates that prevailed in the early 1980's.

These abnormally high yields caused insurers to cut prices radically in order to attract premium dollars which they could invest at rates approaching 20%. Commercial liability lines were deemed particularly attractive since they involved relatively large premiums that could be invested immediately at high yields, while losses might not be payable for several years. New and inexperienced insurers jumped into the market at reduced prices. Insurers pushed to gain market share by dropping their rates. For example, some major corporations could buy excess layers of D&O insurance for as little as $500 per million. As a result of this price cutting, combined ratios for commercial lines began to deteriorate rapidly as insurers competed for premiums. In some cases, premiums were dropping by 20% to 30% per year. This drop in premiums during the "soft market" cycle was, of course, a boon to corporate insurance buyers, many of which took advantage of the situation to purchase very large -- perhaps excessive -- amounts of liability insurance at bargain rates.

Many insurers practiced the policy of deliberately incurring underwriting losses and compensating for these losses by income from investments. This practice is known as "cash flow underwriting." The role of proper premium levels was lost sight of, as premiums became nothing more than an input into an investment machine. Inevitably, interest rates and investment earnings finally began to decline and those earnings could no longer make up for rapidly increasing underwriting losses.

Cash flow underwriting was imprudent not only because it relied on the assumption of ever-increasing investment income, but also because it overlooked the vital function of reserves. Reserves are necessary, among other things, precisely to provide a cushion for fluctuations in underwriting experience (premiums vs. losses). A financial program designed to generate current earnings by offsetting investment income against underwriting losses, thereby creating an overall "business profit" for the stockholders, tended to reduce reserves to dangerous levels.

The unfortunate effects of "cash flow underwriting" were particularly apparent in the reinsurance business. During the "soft" insurance market, reinsurance capacity increased substantially. A number of new entrants came into this field, many of whom had little knowledge of the business that was being written by the primary insurers whom they reinsured. The reinsurers were satisfied to obtain the ceded

premium dollars, which they could invest at high interest rates. On the other hand, the primary insurers also did not exercise adequate control over underwriting, in part because very high percentages of their risks were reinsured. Often, the primary insurer was risking 10% or even less, while reinsuring the balance. The result was that the industry generally was not paying adequate attention to the risks being insured against.

Subsequently, as we know, the prime rate fell rather quickly, as inflation was brought under control. Some underwriters, however, continued to cut premiums, even as losses were rising. Finally, in 1984 and 1985, the property and casualty industry realized the worst underwriting losses in its history.

During 1985, as a result of the losses suffered by insurers, there was a sharp contraction in available D&O coverage. In 1984, more than 30 carriers were offering D&O insurance, and limits of up to $200 million were available. By 1986, many of these carriers had dropped their D&O lines entirely, and those few who continued to provide the coverage were offering drastically reduced limits.[9] Companies that could obtain $100 or $200 million of coverage two years ago may now be very lucky to find $30 million. Premiums have escalated dramatically: increases of 200% to 1,000%, or even more, have been common, particularly in industries regarded by underwriters as especially vulnerable to claims, such as

financial institutions, utilities, chemical companies and "high tech" companies. Some corporations and banks have found themselves unable to purchase D&O coverage at any price.

Policy terms and conditions are also being tightened. A three-year policy was previously standard, but today most D&O carriers are offering only one-year policies. This is a major disadvantage for insureds because D&O insurance is written on a "claims-made" basis and provides no coverage for claims made after the termination of the policy period (and discovery period, if any). Much higher self-insured retentions are being imposed.

Additional exclusions are also being added to policies. One of these is the so-called "insured-vs.-insured" exclusion, which denies coverage for any suit brought by the corporation or by a director or officer against another director or officer. This exclusion was deemed necessary after some corporations (including certain major banks) brought suits against their own officers in an apparent attempt to shift business losses to D&O insurance companies. These suits, together with other major problems in the banking industry, inspired a serious negative reaction among insurers to major financial institution risks.[10] Other exclusions now being commonly inserted into D&O policies include an exclusion for suits arising out of hostile takeovers, an exclusion for suits by regulatory agencies, an

exclusion for prior and pending litigation and sometimes a full exclusion for all acts prior to inception date of the policy. Moreover, traditional exclusions such as the exclusion for dishonesty are being broadened to include fraud and criminal actions.

Although I have dealt with D&O insurance as a special case, the problems affecting the D&O insurance market are not isolated but are an integral part of the overall crisis in liability insurance. As Louis F. Schauer has stated in a report prepared for the Business Insurance Committee of the ABA's Corporation, Banking and Business Law Section:

> "Overcoming the D&O crisis, however, is subject to the solution of broader industry problems of capacity and reinsurance. The problems of D&O availability are but one aspect of a worldwide shortage of capacity for casualty insurance. Capital is not currently being attracted to insure any professional, whether lawyer, doctor, accountant, stockbroker, architect, engineer, realtor, public official or school board member, and carriers have enough asbestos and other environmental impairment problems for generations. Thus, recovery of the directors and officers market is heavily dependent upon and related to the health of the entire casualty market. Speculation on the

timing of the patient's recovery is hazardous at best and causes corporations and their counsel to look to alternative protection for officers and directors."[11]

Even though the D&O insurance crisis is closely related to the overall liability insurance crisis, it has nevertheless had one very particular and disturbing consequence. As D&O insurance has become more costly, or even unavailable, outside directors of some companies have resigned from the board rather than face the risk of personal liability without adequate insurance coverage.[12] The result is that competent outside directors are harder to find than ever before. There is a certain irony in the process that has led to the recent scarcity of directors. Beginning in the early 1970's, academic commentators, the Securities and Exchange Commission and private organizations began to promote the idea that public corporations were not being adequately controlled and that the remedy was to give more supervisory responsibility to outside directors. Only the outside directors, it was argued, were sufficiently independent to protect the interests of stockholders and other corporate "constituencies." Only by giving more power to non-management directors could abuses such as the "foreign payment" scandals be prevented. Audit committees and other committees of the board, consisting principally or wholly of outside directors, became common.[13] Early drafts of the

American Law Institute's "Corporate Governance Project" went so far as to propose that large publicly-held corporations be legally required to have a majority of outside directors and to have audit and other committees with various proportions of outside directors.[14]

As more came to be expected of outside directors, and as their responsibilities grew, it is natural that their potential liabilities also expanded. This expansion of directorial responsibility and liability took place just when other legal and social conditions were producing a litigation explosion throughout the federal and state judicial systems. This combination exposed the personal assets of directors to unacceptable risks. Corporate indemnification, for the reasons mentioned above, was not a satisfactory solution. The availability of D&O insurance during the 1970's created at least the appearance,[15] and in many cases the reality, of adequate protection. At the same time, however, the very existence of D&O insurance provided a powerful incentive for plaintiffs' counsel to bring still more lawsuits against directors, and to draft their complaints so as to bring the allegations within the policy coverage. It is common today for directors and officers to be named as defendants in cases in which they would never have been named 10 or 20 years ago. For example, directors and officers are often named in suits for inducing breach of contract, wrongful discharge, deprivation of pension rights and other alleged corporate

conduct. The obvious purpose of including the directors and officers as defendants is to bring the D&O policy into play. This practice has understandably disturbed D&O underwriters. They believe that the D&O policy is being used as a catch-all funding mechanism for corporate losses of all kinds, a use for which this form of coverage was never intended (and for which appropriate premium levels would be hard to conceive).

As a result of the insurance crisis, many directors are left without even the appearance of adequate coverage. Under the circumstances, it is not surprising that these directors may find that the risks of being a corporate director outweigh the rewards. It thus appears that the well-intentioned effort to force more responsibilities on outside directors may only have contributed to the perverse result of making it unduly dangerous for any reasonable person to serve.

It is, therefore, high time that we went back to basic principles in the field of directors' responsibility. What should we really expect of directors? Should they be liable at all for conduct that falls short of dishonesty, willful misconduct, bad faith or violation of the duty of loyalty? What is the point of holding a businessman's personal assets at ransom because he made a mistake (even a bad mistake), particularly when the availability of D&O insurance may be in doubt?

I submit that the game, as presently played, makes very little sense. Enormous resources are consumed in essentially non-productive legal proceedings. In any situation involving a serious business loss, a good lawyer can almost always find someone who was careless. It is not too difficult to turn this into a case in which the trier of fact is permitted to find that a director or officer was "negligent." The sums of money at stake in these cases are so large that there is an irresistible pressure to settle for very substantial amounts rather than have to face the risk of an enormous judgment. It is no wonder, under these circumstances, that many men and women are reluctant to serve on corporate boards.

There is a great deal at stake in this particular crisis of confidence. American industry must become more competitive to produce jobs and growth for our economy. That is a cliche and hardly needs repeating. But how can we have strong, dynamic, aggressive companies without strong, dynamic, aggressive directors who are willing to take risks? And how can we recruit such directors if we have a legal system that threatens them with personal bankruptcy if, in the light of hindsight, a judge or jury can find that they failed to meet some vaguely-worded standard of care or that their conduct did not measure up to the idealized standard of that hypothetical creature, the "reasonable man?"

The very nature of the capitalist system requires that risks be taken with equity capital. If investors want to

avoid risk, they can invest in bonds or other assets. Presumably, investors who invest in equity securities should expect that risks will be taken with their money. It is perhaps symptomatic of today's risk-averse society that some investors want to have the benefit of the upside potential of risk-taking, but at the same time want to have the right to sue someone if the risk-taking results in a loss. Since some degree of "negligence," as pointed out above, can nearly always be found in a major corporate loss, the law as it presently stands puts the directors constantly in jeopardy of having their decision second-guessed by stockholders (or their lawyers) and by courts.

Thus, the current situation seems to call for additional protection for directors against liability for negligence, at least where the directors have been acting honestly and in good faith. (No one wants to encourage dishonest or disloyal directors, and most of the statutory solutions being considered today exclude any exoneration of directors for such misconduct.)

Possible Legislative Solutions

There are at least three general legislative approaches to the D&O liability crisis that have been proposed.

- Amend the indemnification statute to permit broader indemnification of directors, and/or to permit wholly-owned captives and other self-insurance arrangements

- Adopt a statutory provision which would eliminate or limit the personal liability of directors for breach of fiduciary duty, subject to specified exceptions (or which would permit the stockholders to adopt a charter amendment to eliminate or limit directors' personal liability)
- Change the statutory duty of care from a "reasonable man" standard to a "good faith" standard

(1) Amend the indemnification statute (a) to permit broader indemnification of directors and/or (b) to validate wholly-owned captives and other self-insurance arrangements

(a) An example of the broader indemnification approach is the legislation adopted by New York in June 1986 amending Section 721 et seq. of the New York Business Corporation Law. Among other things, the New York legislation permits a corporation to indemnify a director or officer against amounts paid in settlement (as well as expenses) of a shareholder derivative action if he acted in good faith and for a purpose which he reasonably believed to be in, or, in the case of service for other organizations, not opposed to, the best interests of the corporation (subject to certain exceptions). The statute also makes indemnification for expenses non-exclusive of any other rights to which a director or officer may be entitled under a by-law or agreement.

One difficulty with the New York approach of permitting indemnification for amounts paid in settlement of a derivative action is the circularity of payment. In settling a derivative action (which is an action brought in the right of the corporation), the director pays money to the corporation which, under this type of indemnification statute, the corporation would then pay back to the director. This procedure would appear to benefit no one, except perhaps the attorneys involved. Rather than have the money go around in a circle, why not relieve the director of liability to start with? This consideration suggests that the approach taken by the Delaware legislature, discussed below, may make more sense.

Another difficulty with the New York appraoch is that it may not help much to alleviate the D&O insurance crisis. The reason for this is that most D&O policies cover both the individual directors when they are not indemnified by the corporation and the corporation itself if and when it indemnifies the directors (this is known as the "corporate reimbursement" coverage). Therefore, shifting the liability for settlements from the directors to the corporation does not relieve the insurance company of liability but merely shifts the loss to a different section of the D&O policy (although there may be a higher deductible under the corporate reimbursement section). One possible solution to this problem would be for the insurance companies to write

"directors only" coverage and to drop the corporate reimbursement coverage. I understand that this alternative is now being actively considered by some insurers.

(b) An example of the approach of permitting additional self-insurance arrangements is the legislation adopted by the State of Louisiana in July 1986. (Act 561, July 14, 1986.) Among other things, this legislation provides that a corporation may create a trust fund or other form of self-insurance arrangement for directors and officers and may procure or maintain such insurance with any insurer deemed appropriate by the board of directors regardless of whether all or part of the stock or the securities of the insurer are owned in whole or in part by the corporation. The statute further provides that, in the absence of actual fraud, the judgment of the board of directors as to the terms and conditions of such insurance or self-insurance arrangement and the identity of the insurer or other person participating in a self-insurance arrangement shall be conclusive.

This type of statute is intended to eliminate any argument that insurance provided by a wholly-owned captive would violate the policy behind the indemnification statute.

(2) <u>Amend the corporation law to eliminate or limit the personal liability of directors for breach of fiduciary duty, subject to exceptions, or permit the stockholders to approve an amendment to the certificate of incorporation which eliminates or limits directors' liability</u>

(a) Indiana statute - no stockholder approval required

Indiana has recently amended its corporation law (Indiana Code 23-1-35) by adding a new chapter entitled "Standards of Conduct for Directors." Among other things, this legislation provides (Chapter 35, Section 1(e)) that a director is not liable for any action or failure to act unless (1) the director has breached or failed to perform the duties of the director's office in compliance with the standard of care set forth in this section [the standard "prudent director" rule]; and (2) the breach or failure to perform constitutes willful misconduct or recklessness.

Illinois has followed a similar approach with respect to "not for profit" corporations. A recent amendment to the Illinois General Not For Profit Corporation Act adds a new Section 24b which provides that no director or officer serving without compensation, other than reimbursement for actual expenses, of a corporation organized under the Not For Profit Corporation Act and exempt from taxation pursuant to Section 501(c) of the Internal Revenue Code of 1954 shall be liable for damages resulting from the exercise of judgment or discretion in connection with the duties or responsibilities of such director or officer unless the act or omission involved willful or wanton conduct (as defined).

(b) Delaware statute - stockholder approval required

The Delaware Corporation Law has been amended, effective July 1, 1986, by adding a new subsection (7) to Section 102(b) of Title 8 of the Delaware Code, permitting the

certificate of incorporation to be amended to eliminate or limit the liability of directors in certain cases.

The amendment to the certificate of incorporation, which would have to be approved by stockholders, could contain a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director. However, such provision may not eliminate or limit the liability of a director:

> (1) for any breach of the duty of loyalty to the corporation or its stockholders; (2) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (3) for violations of the Delaware Corporation Law with respect to the declaration and payment of dividends and the repurchase or redemption of shares (which are specifically dealt with in another section of the statute); or (4) for any transaction from which the director derived an improper personal benefit.

It should be noted that this provision applies only to directors and not to officers.

In one sense, the statute sets forth explicitly a standard of care that had previously been assumed to be applicable: namely, that directors are not liable and do not expose their personal assets to lawsuits on behalf of the corporation or its shareholders if they act in good faith and do not participate in transactions in which they had a conflict of interest, so long as any rational business purpose can be attributed to their decisions. This standard has come to be known as the "business judgment rule."

However, as noted previously, some recent cases have cast doubt upon the degree of protection afforded to directors under the business judgment rule. The new Delaware law attempts to redress the balance in favor of the directors.

I believe that the Delaware amendment is a rational approach to some of the problems caused for corporations by the increased incidence of litigation against corporate directors, the resulting lack of availability of directors' and officers' liability insurance and the increased difficulty in finding capable persons willing to serve as directors. I do not anticipate that the implementation of the new Delaware statute will immediately or dramatically improve the availability or the terms of D&O coverage, but, over a period of time, it could help produce a healthier insurance climate. This would be particularly true if other states follow the Delaware approach.

It is my expectation that many, if not most, Delaware corporations will avail themselves of the protection for their directors afforded by the new Delaware law. It is also my expectation that some corporations that are not incorporated in Delaware may consider re-incorporating in Delaware to take advantage of this statute.

A variant of the "statutory limitation" approach that has received some attention is a statutory ceiling on liability of directors. A ceiling would presumably be one of the options available under the new Delaware law, which

permits corporations either to eliminate or "limit" directors' liability, subject to the enumerated exceptions.

A ceiling mandated by statute has also been suggested. Under this alternative, for example, the statute might provide that a director's only liability for a violation of the standard of care could be to make restitution of any direct compensation received from the corporation during the fiscal year in which the violation principally occurred. See the discussion of this proposal in American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Discussion Draft No. 1 (June 3, 1985) at pp. 200-222. In the alternative, a flat dollar ceiling on directors' liability for due care violations could be established. One problem with the cap on liability is that a flat dollar amount is wholly arbitrary and would favor rich directors over poor directors, while a cap based on compensation is also arbitrary because there is a wide variation in directors' compensation. Some directors, for example, get stock options but receive very little monetary compensation. In my view, the monetary ceiling is not the best solution. The best approach is to face up squarely to the question of whether we really want to hold directors personally liable for negligence.

I want to emphasize that the approaches discussed above are only some of the possiblities for protecting directors

against liability. Virtually every state is considering legislation looking toward this general goal. Some states are considering enacting more than one of the above solutions. Many variations are possible.

The point to keep in mind is that we want to enable our corporations to attract and retain qualified directors. In this paper, I have merely tried to suggest some of the possibilities.

Joseph F. Johnston, Jr.

Footnotes

1 For a discussion of the terms and conditions of Directors and Officers Liability Insurance Policies, see Johnston, "Directors' and Officers' and Related Forms of Liability Insurance," 5 Securities Law Techniques Chapter 122 (Matthew Bender 1985).

2 "1984 Directors and Officers and Fiduciary Liability Survey -- Summary Report" (The Wyatt Company) ("The 1984 Wyatt Report").

3 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied 394 U.S. 976 (1969).

4 See Smith v. Van Gorkom, 488 A. 2d 858 (Del. 1985); Joy v. North, 692 F.2d 880 (2d Cir. 1982).

5 See Dela. Corp. Law § 145(b); N.J. R.S. §14A:3-5(b)(3).

6 See discussion in Wander, "Indemnification and Securities Litigation," 5 Securities Law Techniques § 121.04 (Matthew Bender 1985).

7 The 1985 Wyatt Directors and Officers Liability Insurance Survey, at 17. Claim severity refers to the total amount of damages and defense costs paid on a claim or claims.

8 The 1984 Wyatt Report at 8. Wyatt estimated in 1984 that legal costs have recently been increasing at the rate of 10% to 15% per year. Wyatt further estimated

that 8.3% of all D&O claims pending in 1984 would ultimately close with losses of over $1 million.

9 See Report by Louis F. Schauer for the Business Insurance Committee, American Bar Association, Section of Corporation, Banking and Business Law, February 17, 1986.

10 See "Bank of America Loses Liability Policy," American Banker, April 4, 1985, p. 1.

11 Schauer, supra note 9, at 6-7.

12 See "Firms Find Different Solutions to Exodus of Outside Directors," Bus. Ins., January 27, 1986, p. 62; "Additional directors resign," Bus. Ins., February 10, 1986, p. 24; "More Companies Lose Directors to D&O Crisis," Bus. Ins., March 10, 1986, p. 16; "Director Insurance Drying Up," N.Y. Times, March 7, 1986, p. D1; and "Scarce Corporate Directors," N.Y. Times, January 7, 1986, p. D20.

13 See Corporate Directors Guidebook, published by Committee on Corporate Laws of the ABA's Section of Corporation, Banking and Business Law, 1978, p. 31.

14 "Principles of Corporate Governance and Structure: Restatement and Recommendations," A.L.I. Tentative Draft No. 1, Part III (1982).

15 D&O insurance could prove illusory if one or more exclusions from coverage were applicable; or if the insurer succeeded in rescinding the policy because of

misstatements in the policy (even if the outside directors did not know of the misstatements). See Bird v. Penn Central Co., 334 F. Supp. 255 (E.D. Pa. 1971), on rehearing, 341 F. Supp. 291 (E.D. Pa. 1972); and Shapiro v. American Home Assurance Co., 584 F. Supp. 1245 (D. Mass. 1984).

GOOD MORNING.

I AM JOHN R. MULLEN, VICE PRESIDENT, CORPORATE RELATIONS OF JOHNSON & JOHNSON, THE NEW BRUNSWICK BASED HEALTH PRODUCTS MANUFACTURER. JOHNSON & JOHNSON WAS INCORPORATED IN NEW JERSEY ONE HUNDRED YEARS AGO.

WE WISH TO EXPRESS OUR APPRECIATION FOR BEING AFFORDED THE OPPORTUNITY TO OFFER A FEW COMMENTS AT YOUR COMMITTEE'S HEARING TODAY. THE SCOPE OF YOUR INQUIRY WILL BENEFIT ALL NEW JERSEYANS AND ITS BUSINESS COMMUNITY.

QUESTIONS OF THE AVAILABILITY AND AFFORDIBILITY OF DIRECTORS AND OFFICERS INSURANCE HAVE PLAGUED THE BUSINESS COMMUNITY IN RECENT YEARS. THESE QUESTIONS HAVE BEEN THE SUBJECTS OF COUNTLESS ARTICLES IN MAGAZINES, NEWSPAPERS, TRADE AND PROFESSIONAL JOURNALS AND EXPANDING COVERAGE IN RADIO AND TELEVISION PROGRAMS. YOUR OWN INQUIRY IS THEREFORE VERY TIMELY.

MANY THINK THAT THE ISSUE RELATES TO AVAILABILITY AND AFFORDIBILITY OF DIRECTORS AND OFFICERS INSURANCE. BUT IT IS MUCH BROADER THAN THAT. IT RELATES PRIMARILY TO THE NEED TO ATTRACT AND RETAIN THE BEST AND THE BRIGHTEST FOR SERVICE AS CORPORATE DIRECTORS

AND OFFICERS. IT RELATES TO THE ESTABLISHMENT OF AN ENVIRONMENT WHICH ENCOURAGES THEIR ENTREPRENEURIAL SPIRIT AND RISK TAKING. IT IS PURE AND SIMPLY A QUESTION OF GOOD MANAGEMENT AND CORPORATE GOVERNMENT.

MORE AND MORE EXECUTIVES ARE PLACING THEIR OWN FINANCIAL SURVIVALS AT RISK BECAUSE OF THE TREND OF JUDICIAL EXPANSION OF THEIR PERSONAL LIABILITY FOR BUSINESS DECISIONS. UNDERWRITERS ARE DRAMATICALLY INCREASING RATES FOR D&O INSURANCE WHILE CUTTING BACK COVERAGE DRASTICALLY. THERE IS A FEAR WHICH HAS BEEN EXPRESSED BY A NUMBER OF BUSINESS WRITERS THAT JUST AS DOCTORS PRACTICE "DEFENSIVE MEDICINE" IN THE HOPE OF AVOIDING LAWSUITS, BUSINESS EXECUTIVES WITH THE SAME CONCERNS AND MOTIVATIONS ARE BEGINNING TO PRACTICE "DEFENSIVE MANAGEMENT." THE D&O CRISIS IS DETERRING EXECUTIVES FROM SERVING ON BOARDS AND THIS HAS AFFECTED BOTH LARGE AND SMALL BUSINESSES. FEAR OF LIABILITY IS NOW VERY MUCH ROOTED IN THE SUBCONSCIOUS OF DIRECTORS AND POTENTIAL DIRECTORS AND OFFICERS.

EARLY IN JUNE OF THIS YEAR, A GROUP OF APPROXIMATELY EIGHTEEN NEW JERSEY COMPANIES AND MAJOR BUSINESS ASSOCIATIONS BEGAN TO LOOK AT THIS PROBLEM. THE GROUP, WHICH HAS MET MONTHLY SINCE

THAT TIME, EXAMINED THE LEGISLATIVE APPROACHES TAKEN BY THE STATES OF INDIANA, DELAWARE AND NEW YORK TO ADDRESS THESE CONCERNS.

- AN INDIANA STATUTE WHICH BECAME EFFECTIVE IN APRIL OF THIS YEAR EXCULPATES DIRECTORS FROM LIABILITY WITHOUT REGARD TO SHAREHOLDER APPROVAL.

- DELAWARE ADOPTED A STATUTE EFFECTIVE JULY 1, 1986 WHICH AUTHORIZES CORPORATIONS INCORPORATED IN THAT STATE TO INCLUDE IN THEIR CHARTERS OR TO AMEND THEIR BY-LAWS TO ELIMINATE OR LIMIT THE PERSONAL LIABILITY OF A DIRECTOR TO THE CORPORATION OR ITS SHAREHOLDERS FOR MONETARY DAMAGES FOR BREACHES OF FIDUCIARY DUTY EXCEPT FOR

- BREACHES OF THE <u>DUTY OF LOYALTY</u> TO THE CORPORATION OR ITS SHAREHOLDERS;
- ACTS OR OMISSIONS NOT IN GOOD FAITH OR INVOLVING <u>INTENTIONAL</u> MISCONDUCT OR KNOWING VIOLATIONS OF LAW;
- THE PAYMENT OF UNLAWFUL DIVIDENDS OR UNLAWFUL STOCK REPURCHASES OR REDEMPTIONS OR;
- TRANSACTIONS IN WHICH THE DIRECTOR RECEIVED AN IMPROPER PERSONAL BENEFIT.

UNLIKE THE INDIANA STATUTE, THE DELAWARE STATUTE IS AN ENABLING PROVISION ONLY. IT HAS NO EFFECT UNLESS THE CHARTER PROVISION AUTHORIZED BY THE STATUTE IS ADOPTED BY THE SHAREHOLDERS.

IN NEW YORK STATE, GOVERNOR CUOMO SIGNED A BILL ON JULY 25, 1986 WHICH GRANTS CORPORATIONS SPECIFIC AUTHORITY TO INDEMNIFY IN DERIVITIVE ACTIONS AND ADDED A "NON-EXCLUSIVE" CLAUSE SIMILAR TO BUT BROADER THAN THAT CONTAINED IN THE NEW JERSEY STATUTE.

SOME LEARNED WRITERS HAVE SUGGESTED PLACING A DOLLAR CAP ON THE LIABILITY OF DIRECTORS AND OFFICERS ON THE GROUND THAT THEIR EXPOSURE TO LIABILITY IS DISPROPORTIONATE TO THE COMPENSATION THAT THEY RECEIVED.

OUR TASK FORCE IS STUDYING THESE STATUTES AND PROPOSALS AS WELL AS THE NEED TO ENCOURAGE NEW JERSEY'S CORPORATE CITIZENS TO CONTINUE THEIR CORPORATE DOMICILES IN THIS STATE AND NOT BE LURED OFF TO DELAWARE OR SOME OTHER NEIGHBOR WHICH OFFERS GREATER PROTECTIONS AND BENEFITS TO CORPORATIONS AND THEIR DIRECTORS AND OFFICERS. WE ANTICIPATE THAT THIS EXAMINATION WILL BE CONCLUDED IN SEPTEMBER. WE WOULD THEN BE IN POSITION TO MAKE SPECIFIC RECOMMENDATIONS TO THIS COMMITTEE AND OTHER APPROPRIATE LEGISLATIVE

COMMITTEES WITH REGARD TO POSSIBLE AMENDMENTS OF THE GENERAL CORPORATIONS AND BANKING CORPORATION LAWS OF THE STATE OF NEW JERSEY TO ADDRESS THESE PROBLEMS. WE HOPE THAT YOU WILL AFFORD US THE OPPORTUNITY OF PRESENTING OUR RECOMMENDATIONS TO YOU AT THAT TIME.

THANKS YOU.

AUGUST 26, 1986

How To

Tame the Insurance Industry Cycle

and

Make the Legal System More Efficient:

A Suggested Legislative Agenda for 1987

by

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and
Jay Angoff, Counsel
National Insurance Consumer
Organization

Presented at the Annual
Meeting of the National
Conference of State
Legislatures
New Orleans, Louisiana
August 8, 1986

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How to Tame The Insurance Cycle and Make the Legal System More Efficient

I. Introduction and Background

Dramatic insurance premium increases and refusals of insurance companies to write certain types of insurance at any price are now old news. The debate over what is responsible for such price increases and refusals to deal -- an expanding legal system or insurance industry practices and privileges -- is also a familiar one.

Today, the insurance cycle has turned. First quarter 1986 profits for the industry were up 1227%; second quarter profits are likely to be even higher; and profits in 1987 and 1988 will be the highest in the history of the industry, according to Wall Street analysts. While prices will not fall to the same extent that profits have risen, insurers are already beginning to re-enter markets they had withdrawn from, and within six months prices should begin to fall. The insurance crisis thus is coming to an end.

However, the crisis, the legislation enacted in its wake, and insurers' reaction to that legislation has made one conclusion inescapable: limiting the ability of severely injured people to sue and be compensated for their injuries does not bring down insurance rates. For example, during the first half of 1986 a handful of states, notably Washington, Maryland, Colorado and West Virginia, enacted legislation

limiting damages for disfigurement, paralysis, and all other pain and suffering without requiring insurance companies to reduce their rates. After the enactment of such legislation, insurers did not reduce their rates but rather tried to increase them. After Washington enacted a $117,000 to $570,000 cap (depending on the age of the injured person) insurers sought substantial increases but were turned down by Insurance Commissioner Dick Marquardt; 1/ after Maryland enacted a $350,000 cap, the major medical malpractice insurer sought a 50% rate increase, which was granted by Commissioner Ed Muhl; 2/ and after Colorado enacted a $250,000 cap the Hartford, one of the nation's largest insurance companies, announced that it would start cancelling current malpractice policies in November, 1987. This led Republican legislators to charge that "the insurance industry deceived the legislature when it pushed the reforms as dealing with the liability crisis." 3/

The most significant activity, however, occurred in West Virginia. There the legislature passed a bill in March, to take effect in June, that capped damages, required insurer data disclosure and prohibited arbitrary policy

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1/ "The Shockwaves Begin," National Underwriter, May 30, 1986, at 14 (editorial) (characterizing Commissioner Marquardt as saying "You people have said that civil justice abuses have caused rates to soar. We believe you, and so we've acted to curb these abuses. Now its your turn to put up or shut up.")

2/ The Washington Post, July 3, 1986.

3/ Liability Week, Vol. 1, No. 13, July 28, 1986, at 3

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cancellations. In May, the five West Virginia medical malpractice insurers notified all West Virginia doctors that their insurance would be cancelled effective May 31 unless the legislature repealed the disclosure and anti-cancellation provisions of the law. Although the West Virginia Supreme Court enjoined the insurers from leaving the state, the legislature came into special session, repealed the provisions the industry found objectionable, and threw in some additional "tort reform" for good measure. The insurance industry thus successfully blackmailed the West Virginia legislature. 4/

But the industry's West Virginia actions may have ensured that tort reform without insurance reform will never again be enacted. In June, for example, Florida limited damages for pain and suffering to $450,000 but also required insurers to roll back their rates. Several companies promptly threatened to withdraw from Florida and have gone to court to prevent the law from taking effect. Nevertheless, the Governor signed the tort reform/insurance reform package, recognizing that the industry never carried out similar threats to leave the state when Florida rolled back auto and workmen's compensation insurance rates in the early 1970's.

Similarly, in July New York tied tort reform to insurance reform by requiring New York insurers to file new rates "appropriately modified to reflect the likely reductive

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4/ See Business Insurance, May 19, 1986, at 1; Business Insurance, June 9, 1986, at 2.

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cost effects reasonably attributable to any newly enacted statutory provisions of the civil practice law." And in Hawaii, the legislature enacted modest tort reform and mandated 10% to 15% cuts in insurance rates for each of the next three years.

States therefore seem to be beginning to learn that limiting compensation for disfigurement and paralysis will not bring down insurance rates, but that reforming the insurance industry and making the legal system more efficient will. NICO's recommendations in both areas follow.

II. Insurance Reforms

A. Requiring Disclosure

Most industry observers, including many insurance executives, acknowledge that the industry discloses little if any data on actual income and payouts on different types of insurance. 5/ For example, insurers disclose their payouts

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5/ For example, John A. Bogardus, Chairman of Alexander & Alexander, the nation's second largest insurance brokerage, recently told the National Association of Insurance Brokers that "It is damaging to the industry's credibility when we respond with partial, self-serving answers or data that must later be corrected," that "more complete disclosure of claims data and the positive impact various reforms might produce must be forthcoming," and that "the industry gets nowhere by stonewalling these allegations [that profits are being hidden]." Journal of Commerce, May 14, 1986, at 2. Similarly, Kansas Insurance Commissioner Fletcher Bell has emphasized that "adequate, credible and useful statistical data and information is a problem of longstanding," and National Association of Insurance Commissioners President Josephine Driscoll has agreed that " the need for additional information has been more than amply demonstrated." The NAIC News, Vol. III, No. 7, June 1986, at 1.

for a category called "other liability" but not for the specific types of insurance that constitute "other liability," such as day-care, municipal, liquor, nurse-midwife, directors and officers, non-profit organizations, and pollution liability.

Insurers also do not disclose how much they pay out for economic damages - i.e., actual out-of-pocket loss, such as medical expenses and lost wages; for compensatory non-economic damages, such as compensation for paralysis, for the loss of a limb, for the loss of the ability to bear children or for brain damage; and for punitive damages - damages not to compensate the injured person but to punish the defendant and deter similar conduct in the future. And insurers do not disclose how much they pay out after a verdict is rendered (as opposed to the amount of the verdict, which is often dramatically greater than the amount paid out) and the amount they pay out in settlements, the amount they pay to injured people and the amount they pay to their own lawyers and for expenses, and the time that elapses between the insurance company receiving notice of a claim and the company actually paying the claim.

Finally, insurers do not disclose how often they pay claims in cases involving multiple defendants, nor the amount by which their payments in such cases exceed the amount proportional to the fault of their insureds.

Yet the disclosure and analysis of the above information is essential to determine the true condition of the insurance

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industry, as well as the likely effect on both injured people and insurance rates of the various "tort reforms" that are today being considered -- such as limitations on damages for disfigurement and paralysis and punitive damages, and the elimination of joint and several liability. States should therefore require insurers to disclose certain information each year for major classes of liability insurance, including day-care center, products, municipal, medical malpractice, liquor, officers and directors, errors and omissions, and commercial auto. The information disclosed should include the following:

1. the amount paid out in economic damages, compensatory non-economic damages, and punitive damages, tabulated by size of economic damage;

2. the number of claims paid and the amount paid in claims pursuant to (a) verdicts (allocated separately for judge and jury verdicts); (b) settlements after a complaint is filed but before verdict; (c) settlements before a complaint is filed;

3. the total amount rendered in verdicts, and the total amount actually paid out pursuant to verdicts;

4. the average time elapsed between receiving notice of a claim and payment of the claim, by size of claim paid;

5. the investment income earned on the amount ultimately paid between receiving notice of the claim and paying the claim, by size of claim paid;

6. the total amount paid in defense lawyer's fees in connection with claims paid (a) pursuant to verdict; (b)

pursuant to settlements after a complaint is filed but before verdict; (c) pursuant to settlement before a complaint is filed;

7. the total amount paid in defense lawyer's fees in connection with (a) defense verdicts; (b) claims resolved prior to verdict pursuant to which no indemnity was paid;

8. the total amount of all other loss adjustment expenses paid in connection with:

(a) claims paid pursuant to verdict;

(b) claims paid pursuant to settlements after a complaint is filed but before verdict;

(c) claims paid pursuant to settlements before a complaint is filed;

(d) defense verdicts;

(e) claims resolved prior to verdicts pursuant to which no indemnity was paid.

9. the total amount of premiums written;

10. the total amount of premiums earned;

11. in cases involving multiple defendants, (a) the number of claims paid, and the total amount paid; and (b) the amount by which the amount paid exceeded the amount proportional to the insurance company's insured's percentage of responsibility for the injury, as determined by the jury (in cases tried to verdict) or as estimated by the insurer (in cases that are settled).

Data similar to the above on auto accident cases was collected by the U.S. Department of Transportation in the

1970's. The data showed that people who were severely injured in auto accidents received only 50% of their economic loss, while those who were only slightly injured received several times their economic loss. 6/ Based on this study, DOT recommended a no-fault system for small claims: eliminating the right of people with limited damages to sue but in exchange guaranteeing them prompt payment of their economic damages. It did not recommend limiting the amount severely injured people could recover, since they were already being undercompensated. By undertaking studies similar to the DOT study in other areas of tort law, states could intelligently decide what, if any, reforms of the legal and insurance systems make sense.

States therefore should enact legislation requiring the disclosure of the above information (numbers 1 through 11). They may also wish to undertake so called "closed claim" studies which require the disclosure of similar information on a case-by-case basis for claims that have been resolved. Questions that could be included in such a study are attached as Exhibit A.

B. Increasing Competition

1. Repeal anti-group laws

For decades most states have had anti-group laws: laws that prohibit businesses or individuals from banding together

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6/ See U. S. Department of Transporation, Automobile Insurance and Compensation Study, "Economic Consequences of Automobile Accident Injuries," Vols. I and II (April 1970).

to buy insurance as a group or to form a self-insurance group. Members of a self-insurance group, also known as a risk retention group, each contribute money to a pool out of which claims against them are paid.

Anti-group laws were passed at the behest of insurance agents, who earn more money by selling insurance policies one-by-one than by selling a smaller number of group policies (or, of course, by not selling any policies to those who choose to self-insure). As a result, today we have group life and health insurance, but in most states group homeowners and most group commercial liability policies are illegal.

Recognizing the obvious injustice of such laws, Congress in 1981 passed the Risk Retention Act, which pre-empts state anti-group laws and thus allows group purchase and self-insurance, but only for product manufacturers. A bill expanding the Risk Retention Act to apply to all commercial risks was approved in July by the Senate by a vote of 96 to 1 and may be enacted this year. In addition, several states, including Florida and New York, substantially repealed their anti-group laws this year. Because there is no legitimate policy justification for such laws, and because allowing commercial risks to self-insure or form purchasing groups would provide private insurance companies with some much-needed competition, the states should repeal their anti-group laws.

A bill effectively repealing an anti-group law and

permitting commercial risks to buy group insurance is attached as Exhibit B1. A bill expressly permitting self-insurance is attached as Exhibit B2.

2. Allow banks in insurance

A combination of state and federal laws effectively prevents banks in most states from writing liability insurance or even investing in insurance or reinsurance companies. There is a legitimate policy justification for such laws: the fear that a bank would refuse to make loans or provide other services to its customers unless they also purchased insurance from the bank. For example, a bank might refuse to issue a mortgage unless the borrower agreed to purchase homeowners insurance from it. Or it could refuse to make an auto loan unless the borrower agreed to purchase credit life insurance from it.

However, safeguards can be provided to prevent such practices. Given the current state of the insurance market, and the likelihood of similar markets in the future given today's inadequate state regulatory framework, allowing banks to write insurance or at least establish some presence in the insurance industry makes a great deal of sense. Banks are substantially more efficient than insurance companies, have the necessary capital base to write insurance, and want to enter many of the markets from which insurers have withdrawn or in which insurers have raised their rates dramatically. Moreover, even if banks concentrated on personal lines of insurance, such as homeowners and auto, insurance capacity is

fungible, and thus could be redirected toward commercial lines. States should therefore allow banks to enter the insurance industry.

A bill enabling banks to invest in reinsurance companies is attached as Exhibit C.

3. Establish Joint Underwriting Associations

By law, all drivers must have liability insurance, since the states have made the policy judgment that victims of auto accidents should not go uncompensated. Therefore, states have required that an insurer writing auto insurance must agree to insure, at actuarially sound rates, a small percentage of the high risks who can't get insurance in the normal, voluntary market. Such agreements are called assigned risk plans.

Arrangements similar to assigned risk plans, called joint underwriting associations, or JUA's, were created for medical malpractice insurance during the last trough in the insurance cycle in 1975-76. JUA's, like assigned risk plans, provide insurance at actuarially sound rates to those who can't get insurance in the voluntary market. The difference between the two structures is that the JUA itself collects premiums and pays claims, distributing its profits to its members if it makes money and assessing its members if it loses money. The JUA is in effect an insurance company. An assigned risk plan, on the other hand, is simply a mechanism through which high risk applicants apply and are assigned to private insurers who write the policies.

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During the troughs of the insurance cycle, when interest rates are low, JUA's for some professional and commercial risks are as essential as assigned risk plans for drivers, since during those troughs insurers cancel certain classes regardless of risk. During the peaks of the insurance cycle, on the other hand, some insurers insure all commercial applicants regardless of risk. In 1981 for example, with interest rates at 20%, insurers wrote liability coverage for the Las Vegas MGM Grand Hotel fire after it occurred, reasoning that they could take in more by investing the premiums they collected than they would pay out in claims.

Thus, while JUA's are probably unnecessary during cycle peaks, states should have the ability to quickly establish them during cycle bottoms. Like state-run insurance companies, they can both deter West Virginia-style blackmail and provide an alternative insurance source if private insurers attempt such blackmail.

A bill giving the Insurance Department authority to establish a JUA is attached as Exhibit D.

4. Establish state re-insurance programs

Reinsurance is insurance for insurance companies: the insurance company pays the reinsurer a premium, in exchange for which the reinsurer agrees to pay all claims above a certain amount, or agrees to pay a portion of claims according to some formula. For example, in Alabama the major medical malpractice insurer pays all claims of up to $200,000, and a reinsurer, to whom the primary insurer has

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paid a premium, pays any amount above $200,000. Reinsurance thus can insure insurance companies against very large claims.

Small businesses and others who decide to form groups to self-insure may find it relatively easy to set aside an amount sufficient to pay typical claims, but quite difficult to set aside enough to pay the unlikely but possible extremely large claim. They will therefore need to buy reinsurance. During the peaks of the insurance cycle, this presents no problem; during cycle bottoms, on the other hand, reinsurance is often even harder to find than primary insurance. This is especially true today, with Lloyds of London and Weavers of London, the dominant reinsurers, blanketly refusing to insure many U.S. risks. Many explanations for such refusals have been offered, including unprecedented embezzlements by Lloyd's insiders, the drop in the value of the pound from $2.80 in 1965 to $1.05 in early 1985 which made payments in dollars to U.S. insureds much more costly for British companies, and pressure from American insurers to reinforce their efforts to pressure legislatures into limiting liability. 7/

To ensure that businesses and others who self-insure will be able to purchase re-insurance even during insurance cycle bottoms, states should establish their own

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7/ See, e.g., Business Insurance, July 21, 1986, at 2; Chicago Tribune, October 20, 1985, at 5; Business Week, August 5, 1985, at 57; Journal of Commerce, July 26-27, 1985.

72x

reinsurance programs. Self-insureds would pay the state a premium, in return for which the state would agree to pay all claims above a specified amount. If efficiently run, government-run reinsurance programs can make money. An example is the federal riot insurance program, which Congress established in 1968 to reinsure insurers of riot-caused damages. This program made a profit of $125 million while keeping insurance available in inner cities.

A bill establishing a state reinsurance program for self-insureds is attached as Exhibit E.

5. Establish state-run insurance companies

Many states currently run successful insurance programs themselves. In some cases, the state-run company has a monopoly, as it does in five states with workmen's compensation insurance. In others, the state-run company competes with private insurers, as do 13 state-run workmen's compensation carriers. 8/

All state funds, whether monopolistic or competitive, have two advantages over private insurance companies: they need not make a profit but need only break even, and they do not pay state taxes. In addition, a monopolistic state fund can spread the risk over all policyholders in the state. And a monopolistic state fund can operate on a "pay-as-you-

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8/ U. S. Chamber of Commerce, Analysis of Workers' Compensation Laws at 39 (1980).

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go" plus safety margin basis. By law, an insurance company must have sufficient capital to immediately pay not only all claims it knows of but also all claims it predicts it will pay in the future - over several years or even decades - on current policies. The company must also have sufficient capital to pay the amount it would owe all its policyholders on the unexpired portions of their policies if all policyholders cancelled their policies immediately. And the company must have an additional amount - typically a few million dollars - set aside as surplus.

For private insurance companies, these requirements make sense: if a private insurer becomes insolvent claimants may well go uncompensated, because most state insolvency funds are so undependable. A state-run insurance company with a monopoly, on the other hand, has a guaranteed market and guaranteed source of funding. Such a company need not characterize the entire amount it estimates it will pay out in the future on current policies as a liability, as private insurance companies do, and consequently it can charge lower rates.

Finally, state-run insurance companies, whether monopolistic or competitive, should be able to run much more efficiently than many private insurers. For example, according to data recently submitted by the Insurance Services Office to House Judiciary Committee Chairman Peter Rodino (D-N.J.), for each dollar businesses pay in premiums for product liability insurance, insurance companies pay out

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$.29 in claims and defense costs. 9/ The states have proved they can do a better job. In Ohio, for example, the state-run workmen's compensation fund takes in only $.84 for every dollar it pays to injured workers, while privately-run workmen's compensation carriers take in as much as $1.45 for every dollar they pay in benefits. 10/

Perhaps most important, state insurance programs may be the most effective response to insurers who threaten to withdraw from states in order to pressure legislators to repeal legislation insurers find objectionable, as occurred in West Virginia and as is occurring in Florida. The existence of such programs both makes it less likely that private insurers will withdraw and ensures that policyholders have an alternative insurance source if private insurers do withdraw.

A statute authorizing a state-run insurance company is attached as Exhibit F.

6. Establish interstate compacts

What occurred in West Virginia highlighted the gross disparity of bargaining power between a small state and the insurance industry. West Virginia is a very small market for malpractice insurers, with West Virginia doctors accounting

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9/ See House Judiciary Committee press release, June 9, 1986 (data "undermines the companies' claims of massive losses and raises the specter of price-gouging." according to Chairman Rodino).

10/ A. Tobias, The Invisible Bankers, 168 (1982)

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for a tiny faction of U.S. malpractice premiums; malpractice insurers therefore would lose very little by withdrawing from West Virginia. For West Virginia doctors, on the other hand, malpractice insurance is essential. Both the malpractice insurers and the legislature recognized this, which is why the malpractice insurers won.

West Virginia could have fought back by starting its own insurance company. West Virginia also could have fought back by establishing an interstate joint underwriting association together with several other larger states -- say Ohio, Pennsylvania and New York. Under such a plan, as a condition of writing insurance in any of the member states an insurer would have to agree to insure a certain percentage of the risks in each state. Thus, if an insurer wished to withdraw from West Virginia it could do so -- but it could then no longer write insurance in New York, Pennsylvania or Ohio either, each of which is a huge insurance market. Insurer blackmail would therefore be much less likely.

States could also establish joint re-insurance programs. For example, if New York, Pennsylvania, Ohio and West Virginia established such a program, as a condition of doing business in any of those states an insurance company would be required to contribute a small percentage of its premiums -- say, 1/4 of 1% -- to fund a joint program that would write reinsurance in all four states, under underwriting and other standards established jointly by the member states.

A draft bill establishing an interstate re-insurance program is attached as Exhibit G.

C. Regulating More Effectively

1. Prohibit arbitrary cancellations

Under current law, insurance companies may cancel a policy at any time, without notice, for any reason or for no reason. During the peaks of the insurance cycle - when interest rates are high and insurers are therefore earning substantial investment income - they rarely, if ever, arbitrarily cancel policies. During the troughs of the insurance cycle, on the other hand, when interest rates and therefore insurers' earnings on their investments are low, insurers cancel even excellent risks, arbitrarily and without notice. This is the case today, and was the case 10 years ago.

The states should enact legislation that would prohibit midterm cancellations unless the policyholder has engaged in fraud or has failed to pay his premiums or there has been a change in the underlying risk. It is fundamentally unfair for a policyholder, who has entered into an insurance contract for a specified term, to suddenly find that contract cancelled before that term runs.

Nonrenewals, on the other hand, should be permitted, but only if the insurer gives the policyholder adequate notice of its intent not to renew, and a statement of reasons for not renewing.

Bills restricting cancellations and nonrenewals are

attached as Exhibits H1 and H2.

2. Require experience rating

Good drivers pay less than bad drivers for auto insurance, and homeowners who are good risks pay less than those who are bad risks. In contrast, in most states, good doctors and bad doctors pay the same rate: a doctor who has been successfully sued for malpractice several times pays the same rate as a doctor who has never had a claim against him. Many other professionals and small businesses also pay a set rate regardless of their individual claims experience, i.e., they are not experience-rated.

By requiring insurance companies to experience-rate all professional and commercial risks, just as they experience-rate drivers and homeowners, states could reduce insurance rates for most insureds. This is particularly true for medical malpractice insurance, since studies have consistently shown that a very small percentage of doctors is responsible for a very large amount of the malpractice. 11/ Absent experience rating, therefore, the majority of doctors, who rarely if ever engage in malpractice, subsidize the small minority of doctors who are frequent malpractitioners.

11/ See, e.g., Michigan Report on the Liability Crisis at 11 (1985) (19.3% of doctors accounted for 72.2% of claims; 58.1% had no claims); Florida Insurance Commissioner, Closed Claims Study of Medical Malpractice Insurance, 1975-82 (1983) (0.7% of doctors accounted for 24% of claims; one doctor for 31 claims); S. Ferber & B. Sheridan, "Six Cherished Malpractice Myths Put To Rest," 52 Medical Economics 150 (1975) (0.6% of Los Angeles doctors accounted for 30% of all payments).

A bill requiring experience rating is attached as Exhibit I1. Regulations specifying how doctors can be experience rated are attached as Exhibit I2.

3. Establish flex-rating

If insurance companies were fully subject to the antitrust laws, then rate regulation might be unnecessary; the market would determine the proper level of rates. However, because under the McCarran-Ferguson Act insurers may legally fix prices and engage in other anticompetitive activity, regulation of insurance rates is essential.

To allow the market to work as competitively as possible despite McCarran-Ferguson, insurance companies should be permitted to raise or cut their rates without approval by the insurance commissioner within a "zone of reasonableness" - say, 15% above and 15% below the existing rate. Above or below that rate, however, states should not permit a rate to take effect unless and until the insurance comissioner approves the rate. Requiring such prior approval of rates except those within the zone of reasonableness should both smooth out the insurance industry cycle and enhance competition in the industry.

A bill requiring prior approval of insurance rates except those within a zone of reasonableness - so called "flex-rating" - is attached as Exhibit J.

4. Beef up enforcement

It is well-established that state insurance departments

are understaffed and underfunded. According to the 1986 Yearbook of the American Academy of Actuaries, for example, 26 states have no actuaries - people who have been professionally trained to determine the adequacy of present rates on the basis of past claims experience. Moreover, of the 8,000 actuaries in the United States, only 64 are employed by state insurance departments; Aetna alone has twice as many actuaries as all the states combined.

The result is that insurance departments, no matter how dedicated, can not meaningfully scrutinize insurance company requests for rate increases; as Ken Merin, New Jersey's new insurance commissioner, has said, insurance departments often are simply "out-manned and out-gunned." 12/ Often, therefore, rate increase requests are effectively rubberstamped.

State insurance departments are similarly lacking in investigators, auditors and other professionals, as the U. S. General Accounting Office has found. 13/ Specifically, the GAO found that "most states do not have specialized examiners and few states have the capacity to do computerized audits," that "the authority of departments to order corrective action is very limited," and that only two of the 17 states it examined "conducted an original actuarial analysis enabling

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12/ Journal of Commerce, July 8, 1986, at 1.

13/ See U.S. General Accounting Office, Issues and Needed Improvements in State Regulation of the Insurance Business (October 1979).

them to independently recommend the appropriate level of insurance rates."

The states should pass legislation requiring insurance departments to have on staff a specified number of actuaries auditors, investigators and other professionals, and appropriating adequate funding for such positions.

5. Close the "revolving door"

While some insurance commissioners are dedicated to the public interest and do yeoman work with limited resources, others lack the will to stand up to the insurance industry. For example, the GAO study found that most regulators do not have an "arms-length relationship" with the industry, and that about half of all insurance regulators come from and return to the insurance industry.

Clearly, prior experience in the insurance industry yields expertise helpful in regulating the industry. Conversely, one can learn much about the industry from regulating it, and can use that knowledge productively within the industry after leaving the insurance department.

Yet regulators must always hold uppermost the broad public interest, not the narrow, albeit legitimate, private interests of insurance companies, and an insurance commissioner must never allow his vigilance in guarding the public interest to be compromised by his looking toward a future job within the industry. Therefore, to eliminate the appearance of any conflict of interest, states should pass

legislation that would require state insurance commissioners to wait five years before going to work for any company they had regulated.

States should also seriously consider as candidates for insurance commissioner qualified individuals who have not worked in the insurance industry.

A bill that has gathered substantial support in Congress in the wake of the Michael Deaver scandal, which can be adapted to apply to state insurance commissioners and the insurance industry, is attached as Exhibit K.

6. Establish an Office of Insurance Consumer Advocate

Perhaps because insurance is such an arcane and seemingly boring issue, the consumer is rarely if ever represented in insurance rate hearings. This lack of consumer presence is compounded by the lack of an "arms-length relationship", as the GAO study put it, between the insurance industry and insurance regulators.

An insurance consumer advocate would represent the consumer point of view at rate hearings and ensure that the insurance department does not rubber stamp insurance company rate requests. An insurance consumer advocate might also cause insurance companies to moderate their requests for rate increases. A handful of states (South Carolina, Maine, Oklahoma and New Jersey) have already established such offices. New Jersey's is particularily effective: the cost of the consumer advocate's intervening is billed back to the insurance company seeking the rate increase, thus creating an

incentive for the insurer to keep its rates down in hopes that the consumer advocate will not intervene.

The New Jersey statute creating such a system is attached as Exhibit L.

7. Prohibit the pass-through of lobbying expenses

Like other industries, the insurance industry engages in expensive lobbying and public relations campaigns on controversial issues. For example, since December, 1984 the industry has been engaged in a "massive effort to market the idea that there is something wrong with the civil justice system in the United States," as the Insurance Information Institute has put it. 14/ And in January of this year, the industry embarked on a $6.5 million advertising campaign designed, again in the III's words, to "change the widely-held perception that there is an insurance crisis to a perception of a lawsuit crisis." 15/

While insurance companies clearly have the right to seek to manipulate public opinion, whether they have the right to charge their policyholders for the cost of such manipulation is less clear. To ensure that the insurance industry does not charge its policyholders for lobbying/public relation efforts that many of those policyholders may not agree with, may be adversely affected by, and may believe to be false and misleading, states should enact legislation prohibiting the

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14/ National Underwriter, December 21, 1984, at 2.

15/ Journal of Commerce, March 19, 1986, at 1, 20.

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insurance commissioner from approving any rate increase to the extent that it includes expenses for public relations and lobbying. Under such statutes, insurance companies' first amendment rights to conduct expensive lobbying and public relations campaigns -- even false and misleading ones -- would be preserved; their policyholders would simply not have to pay for them.

Passing through the cost of lobbying and public relations to consumers is a particularly stark example of a larger problem: insurers blanketly passing through to policyholders all their expenses, rather than allocating those expenses by type of expense and by state. Policyholders thus end up paying for expenditures -- from charitable contributions to executive compensation -- that should more appropriately be borne by stockholders, and policyholders in low expense states end up subsidizing policyholders in high expense states.

Recently, the Supreme Court of Oklahoma ruled that insurance companies must provide "detailed evidence" of their expenses when seeking rate increases. 16/ If other states follow this decision, or legislatures codify it, rates should fall somehat - perhaps substantially - and should more accurately reflect insurers' activities in each state.

16/ State of Oklahoma v. Oklahoma State Board for Property & Casualty Rates, No. 65,430, slip. op. at 13 (Oklahoma Supreme Court, decided July 24, 1986).

D. Require risk management

Many insurance buyers have not established risk management programs - i.e., they have not set up procedures intended to eliminate, to the greatest extent possible, dangerous aspects of their operation. Perversely, insurance companies and agents also have limited incentives to encourage insurance buyers to set up risk management programs, since the greater the risk the greater the premium, and thus the greater the profit to both the company and the agent, whose profits are calculated as a percentage of the premium.

However, states can pass laws requiring insurance purchasers and self insureds to set up risk management programs. For example, hazardous waste insurers wrote even bad risks at very low rates in the early 1980's, and refused to write even good risks - at any price - during the last year or so. However, if insurers try to control risk through careful, ongoing risk monitoring and control, rather than merely collecting and investing premiums and paying out claims, insurers can make money by writing even hazardous waste insurance.

Elevator and boiler and machinery insurance provides an instructive analogy. In their infancy, elevators and boilers were both quite dangerous, since elevator cables could break and boilers could explode. Insurers, however, insisted that those risks be managed - for example, that cables be strengthened and that boilers be monitored - before agreeing

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to write elevator or boiler and machinery insurance. As a result, elevator and boiler accidents are today virtually unheard of. Insurers should spend more of their premium dollar on engineering, and insist that risks seeking hazardous waste insurance first obtain an "environmental audit" and take steps to minimize both the possibility that hazardous substances will be released and the extent of the harm should any such release occur. In that way insurers can both make money and encourage a safer environment.

A bill requiring municipalities which self-insure to set up risk management programs is attached as Exhibit M.

E. Allocate medical malpractice insurance costs more equitably

The problem with medical malpractice insurance is not its total cost -- $3.4 billion 17/ or 8/10 of 1% of the $425 billion 18/ spent on medical care in 1985 -- but its allocation.

The costs of the system are misallocated in four major ways. First, doctors in high-risk specialities pay for risks that should be shared by others. The medical profession may be viewed as a pyramid, with a base of thousands of general practitioners and an apex of relatively few high-risk specialists. The patient is pushed up the pyramid as his

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17/ Best's Insurance Management Reports, Insurance Premium Distribution - 1985, Release No. 22, July 21, 1986.

18/ The Washington Post, July 30, 1986, at 6.

case and its treatment become more complex. As the case gets more difficult and slight error more devastating, fewer and fewer doctors are asked to bear the cost.

For example, a man may go to see his family doctor because he has blood in his urine. The G.P. may send him to a urologist, the urologist may order x-rays, on the basis of those x-rays the urologist and radiologist may determine that the man has kidney cancer, a surgeon may partially remove the cancer, and a radiation oncologist may then treat the patient with radiation. Assume that the radiation oncologist radiates the wrong kidney and the patient dies. Under the current medical malpractice insurance system radiation oncologists must bear the cost of that mistake. Were it not for the diagnosis and treatment of many other doctors at different levels of the pyramid, however, the radiation oncologist would never have treated the patient. If doctors on lower levels of the pyramid bore a small portion of the cost of a mistake by doctors on higher levels -- on the rationale that all doctors benefit economically by treating patients on whom specialists undertake high-risk procedures -- the cost of malpractice insurance for high-risk specialists would go down. In addition, such a system would give all doctors a greater incentive to exercise due care in referring patients.

Second, doctors are broken down by insurance companies into too many categories, with too few doctors in some categories. In Wisconsin, for example, the few dozen

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neurosurgeons in the state traditionally have constituted one category. Thus, if an insurance company pays a major claim against one neurosurgeon it must raise rates substantially to all neurosurgeons -- there are simply too few doctors in the category among whom to spread the risk. If insurers were required to put all doctors into three or four categories rather than the dozen or so they do today, an adequate spread of risk would exist in all categories. Doctors who are today paying exorbitant premiums would pay substantially less, while doctors paying very little today would find their premiums rising slightly. The statute recently enacted in Wisconsin requiring that doctors be grouped into no more than four categories is attached as Exhibit N1. A chart showing the effect on premiums of collapsing nine doctor classifications into three is attached as Exhibit N2.

Third, today doctors pay for malpractice that could more easily be borne by hospitals. Whenever a doctor makes a mistake, whether in making a diagnosis in his office or conducting a procedure in a hospital, the doctor pays. Charging hospitals for part of the cost of malpractice occurring in hospitals would have two positive effects. Because hospitals have a very large number of beds over which to spread risk, hospitals could bear the cost of malpractice occurring in hospitals better than doctors. And requiring hospitals to pay for malpractice occurring there would encourage them to make sure that the doctors to whom they grant privileges are competent.

Fourth, doctors, unlike drivers and homeowners, are not

experience rated, so that the many doctors who are rarely if ever negligent subsidize the few doctors who are frequently negligent. If doctors were experience rated, so that those frequently involved in malpractice paid more and those with good records paid less, this subsidization would stop and most doctors would pay less. Experience rating would thus increase each doctor's incentive to exercise due care. Regulations implementing experience-rating of doctors are attached as Exhibit I2.

In addition, of course, doctors do a notoriously bad job of disciplining their own. Insurance companies should disclose all payments they make in connection with malpractice claims, and the names of doctors involved in those claims, to the Department of Insurance, and the Department of Insurance should make such information available to medical licensing boards, hospitals, professional review organizations and the public. Such disclosure would enable doctors to weed out the "bad apples," thus reducing the incidence of malpractice and consequently reducing malpractice insurance rates. Moreover, such disclosure would be invaluable to the consumer in choosing a doctor.

A bill requiring disclosure of payments in medical malpractice cases is attached as Exhibit O.

III. How to Make the Legal System More Efficient

There is a difference between "tort reform" and true legal reform. "Tort reform," in the sense in which it is

used by insurers, simply means limiting liability: making it more difficult to sue and more difficult to win, and limiting compensation -- particularly for "non-economic" injuries such as disfigurement and paralysis -- for people who do sue and win.

Limiting liability, however, does nothing to reduce the overall costs of the legal system by making it more efficient, e.g., by reducing delay, or increasing the proportion of the money flowing through the system that actually reaches the injured person. NICO's recommendations for making the legal system more efficient follow.

A. Limit lawyer's fees on both sides.

Should government limit legal fees? On the one hand, principled conservatives, including Senate Commerce Committee Chairman John Danforth (R.-MO), have forcefully argued that an administration which has sought to deregulate airlines, communications, banking and other endeavors ought not single out lawyers' fees for regulation.

On the other hand, the Reagan Administration has sought to limit plaintiff's lawyer's fees -- to 25% of the first $100,000 recovered, 20% of the next $100,000, 15% of the next $100,000 and 10% of anything above $300,000. It has not sought to limit defense lawyers fees. Because the relationship between a defense lawyer and his corporate client is a roughly equal one, whereas the relationship between a plaintiff's lawyer and his client -- a scared, unsophisticated injured individual -- is grossly unequal,

plaintiffs arguably need protection by the government that defendants do not.

The Administration's sliding scale, however, would not protect plaintiffs from overreaching plaintiff's lawyers but rather would limit the ability to sue of those people who have been seriously injured by a defective product or a negligent doctor or hospital. For example, one law firm representing several women rendered infertile by the Dalkon Shield IUD had to spend $800,000 before recovering a penny from A. H. Robins, the manufacturer of the Shield. 19/ Under the Administration's proposal it would not be economically feasible to bring such a case, since defense fees and defense tactics -- and therefore plaintiff's lawyers' costs -- remain unlimited, while the plaintiff's lawyer's reward for winning the case is sharply limited.

If lawyers fees are to be limited, they should be limited on both sides. The fastest growing expenditure in the legal system is not plaintiff's lawyer's fees - which are typically 1/3 of the recovery if they win and nothing if they lose - but defense lawyers fees. According to the Insurance Services Office, for each dollar insurers pay to injured people they pay $.46 to defense lawyers -- double the amount they paid to defense lawyers just ten years ago. 20/ And

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19/ Robins, Zelle, Larson & Kaplan, "The Bomb in the Boardroom," Nov. 15, 1984, Minneapolis, MN (seminar) (Statement of Robins, Zelle, attorney Roger P. Brosnahan).

20/ Insurance Services Office, Inc., The Rising Costs of General Liability Legal Defense, at 3 (May 1986).

since 1956, defense lawyers' fees have risen three times as fast as claims payments. 21/

The rise in defense costs is particularly alarming because each additional dollar spent on defense lawyers means an additional dollar that must be charged directly to policyholders; increasing defense costs thus directly increases insurance rates. The amount the plaintiff spends on his lawyers, on the other hand, has no effect on premium rates, since rates are based on the amount of the jury verdict or settlement, not the percentage of that verdict or settlement that goes to the plaintiff's lawyer.

States could limit defense fees by disapproving any rate that included within it more than a certain percentage -- say 25% -- for defense costs. Under such a plan, the amount spent on defense costs is limited, but the insurer has the ability to determine how best to allocate that amount. With lawyers fees limited, a greater percentage of the money flowing through the system would wind up in the hands of the injured person.

A bill taking an extremely modest first step toward controlling lawyers fees on both sides is attached as Exhibit P.

B. Penalize frivolous actions on both sides

Just as insurers have sought to limit plaintiff's but

21/ Insurance Services Office, Inc., and National Association of Independent Insurers, "1985: A Critical Year" (May 1985).

not defense lawyers' fees, they have sought to penalize frivolous actions by plaintiffs - frivolous suits -- but not frivolous actions by defendants - frivolous motions and objections.

In fact, however, much greater incentives exist for the latter than for the former: because they charge by the hour, defense lawyers have an incentive to "keep their meter running" by raising defenses, filing motions, interposing objections and briefing and rebriefing the same issue -- no matter how untenable their position -- even if settling the case quickly would actually be cheaper for their clients. Plaintiff's lawyers, in contrast, have no incentive to delay, since they work on a contingency fee basis, getting paid only if and when they win.

States should enact legislation establishing severe sanctions, or encouraging judges to impose such sanctions, for delaying tactics or actions taken in bad faith, whether by plaintiff or defense lawyers. Possibilities include:

1. The judge could order that the party found to be acting in bad faith pay the attorney's fees involved in opposing the action found to be in bad faith, perhaps with an additional penalty;

2. The judge could direct a verdict on the issue or issues dealt with in bad faith against the party found to be acting in bad faith;

3. The judge could direct a verdict in the entire case against the party acting in bad faith;

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4. Lawyers found to be acting in bad faith could be suspended;

5. Lawyers found to be continually acting in bad faith could be disbarred.

Bills imposing modest penalties for frivolous actions are attached as Exhibits Q1, Q2 and Q3.

C. Prohibit secrecy agreements

What does a lawyer do when a defendant offers to settle his client's case for a generous amount, but only on condition that the settlement agreement remain sealed and that all material discovered during the case be returned or destroyed? The settlement is clearly in the individual client's best interest, but equally clearly can be contrary to the public interest: it may allow the manufacturer to continue to market a product it knows is defective, it causes more people to be killed and injured by that product, and it makes it more difficult for other people injured by the product, or the families of those killed by the product, to receive compensation.

Perhaps the most sordid and well-known example of a corporation insisting on secrecy agreements is that of A. H. Robins in Dalkon Shield cases; 22/ today, Honda and the other

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22/ See Remarks of Miles Lord, Chief Judge, District Court for the District of Minnesota, to Messrs. Robins, Forrest and Lunsford of A.H. Robins Co., Feb. 29, 1984 ("In order that no group of plaintiffs might assert a sustained assault upon your system of evasion and avoidance, you time after time demand that able lawyers who have knowledge of the facts must, as a price of getting their cases, agree to never again take a Dalkon Shield case nor help any less experienced lawyers with their cases against your company.")

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manufacturers of 3-wheel All Terrain Vehicles (ATV's), which have already been responsible for almost 200 deaths, are insisting on similar agreements.

To eliminate the conflict between the individual client's interest and the public interest, to reduce costs and to save lives, states should prohibit secrecy agreements.

A draft bill prohibiting such agreements and accompanying explanations are attached as Exhibit R.

D. Encourage offensive collateral estoppel

Under the doctrine of collateral estoppel, a party that has had a full and fair opportunity to litigate a fact at issue is not permitted to relitigate that issue in case after case; rather, the fact is established and can be used in future cases.

Judges have been hesitant to allow the use of collateral estoppel by plaintiffs, even though allowing such use would substantially speed up the resolution of cases. Taking the Dalkon Shield example again, in case after case A. H. Robins argued that the Dalkon Shield was not defective, even as court after court found that it was defective; had the defectiveness of the product been deemed established early in the litigation, with liability then depending on whether or not there was causation in each individual case, costs on all sides would have been substantially reduced. 23/

23/ See M. Mintz, At Any Cost: Corporate Greed, Women and the Dalkon Shield (1985).

E. Pass back collateral source benefits

Under current law in the majority of states, the jury is not permitted to hear evidence of any payments the plaintiff may receive for his injury from sources other than the defendant, e.g., workmen's compensation benefits, health insurance benefits, or social security benefits. In some states the jury may consider such evidence, and in a few states the jury verdict is automatically reduced by the amount of benefits from these "collateral sources."

The majority rule -- the so-called "collateral source rule" -- presents a difficult issue. On the one hand, a defendant who has negligently caused an injury certainly does not deserve a windfall because the plaintiff happens to have insurance or is eligible for other benefits. On the other hand, a plaintiff who receives compensation for medical expenses from both a jury verdict and another source receives double recovery to the extent medical expenses paid by the other source exceed the payment he has made to that source, such as premiums for health insurance.

To prevent both windfalls to defendants and double recovery for plaintiffs, the fairest solution is probably to require the defendant to pay the full amount of the verdict, but to excuse the source of the collateral benefits from paying such benefits to the extent that they are already included in the jury verdict. With the money thereby saved, the source of the collateral benefits would be required to reduce the cost of those benefits across the board. For

example, if the jury verdict included compensation for lost wages, and the plaintiff was eligible for workmen's compensation benefits, the defendant would pay the full amount of the verdict to the plaintiff and the plaintiff's workmen's compensation carrier would be excused from paying the plaintiff, but would be required to pass through the savings by reducing its rates across the board.

Under this rule, the cost of health insurance and workmen's compensation insurance should fall by 10-15%, and transaction costs would be reduced. And taxpayers, workers and purchasers of health insurance would not subsidize liability insurers, as they would if jury verdicts were reduced by collateral source benefits.

F. Create incentives to settle.

Because they're paid by the hour, defense lawyers have an incentive to keep their meters running by delaying the resolution of cases -- even those where liability is clear -- to the greatest extent possible.

Penalizing defendants for refusing to make reasonable offers, and penalizing plaintiffs for making unreasonable demands, would encourage both sides to be more reasonable more quickly in negotiating and thus to resolve cases more quickly.

A bill penalizing both the failure to accept a reasonable offer and the making of an unreasonable demand is attached as Exhibit S.

G. Establish alternatives to the tort system - including

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no-fault systems, arbitration, mediation, mini-trials, and other alternative dispute resolution systems

The tort system serves three important functions: compensation, deterrence and disclosure. Because no effective criminal penalties exist to deter corporations from acting irresponsibly, the tort system provides the only meaningful deterrent to such actions. And because government regulators can not be depended on to ferret out information that corporate defendants do not wish to disclose, the tort system is the only means to force disclosure of such information. The stories of A. H. Robins and the Dalkon Shield, 24/ Ford and the Pinto gas tank, 25/ Richardson-Merrell and MER-29, 26/ and Johns- Manville 27/ and asbestos are just a few of the scandals unearthed as a result of tort litigation. And it was only the fear of more litigation, and of large awards for both compensatory and punitive damages, which finally forced these and other dangerous products off the market and encouraged the development of less dangerous substitutes.

It is therefore essential that the common law continues to develop and that no limits be placed on either

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24/ See id.

25/ See Grimshaw v. Ford Motor Co., 174 Cal. Rptr. 348 (1981)

26/ See Toole v. Richardson-Merrell, 251 Cal. App. 2 689 (1967).

27/ See P. Brodeur, Outrageous Misconduct: The Asbestos Industry on Trial (1985).

compensatory or punitive damages in cases involving defective products.

In other types of cases, on the other hand, factors other than the tort system may deter irresponsible conduct or force disclosure - or deterrence and disclosure may be less important - and another type of system might compensate people more efficiently than does the tort system. The classic example is no-fault auto insurance. Both criminal penalties and self-interest deter people from driving recklessly, and when the police arrive at the scene of an auto accident it becomes a matter of public record. A no-fault insurance system which neither deters reckless conduct nor forces disclosure but does compensate people more efficiently than does the tort system therefore makes sense for auto accidents. Up to 95% of each dollar flowing through such systems reaches the injured person, compared to less than 50 % of each dollar in the tort system.

For other types of uncomplicated cases involving relatively minor injuries, such as many slip-and-fall cases, no-fault systems may also be worth trying. For example, states may wish to consider a no-fault system with an add-on penalty for deterrence for all cases not involving death, disfigurement or permanent disability in which the plaintiff's economic loss was less than a certain amount. Under such a system, if the injured person sought payment of his economic loss from a defendant causing the injury, and the defendant failed to pay such economic losses within 30 days, the defendant would automatically be penalized heavily,

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e.g., by being required to pay treble damages. Such a system might well provide a sufficient deterrent to run-of-the-mill negligence causing relatively minor injury, although it would not force any disclosure.

In addition, for parties with roughly equal bargaining power -- such as an asbestos manufacturer and its insurer or two major manufacturers -- other less costly alternatives to the tort system may make sense. Corporations that have frequent business dealings with each other, for example, can provide by contract that any disputes between them be resolved by binding arbitration, or by "mini-trials" that are much less formal and expensive than full blown trials.

Finally, in certain cases the tort system has worked exactly as it is supposed to: litigation and substantial damage judgments have not only compensated injured people but have also stopped irresponsible actions, or forced responsible ones, and have enabled the public to learn the truth about outrageous corporate misconduct. After the corporation and its officers are punished adequately, many still-uncompensated victims of the product might be more quickly and adequately compensated through an alternative dispute resolution system than through the tort system.

Bills establishing various types of alternative dispute resolution systems are attached as Exhibits T1, T2 and T3.

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TESTIMONY

OF

JAMES F. JOHNSON

LeBoeuf, Lamb, Leiby & MacRae

BEFORE

THE

SENATE LABOR, INDUSTRY AND PROFESSIONS COMMITTEE

NEW JERSEY STATE LEGISLATURE

August 26, 1986

101x

Mr. Chairman, Members of the Committee.

I am James F. Johnson. I am a partner in the law firm of LeBoeuf, Lamb, Leiby & MacRae which has offices in New York, Newark and Metro Park. For the past twenty years I have specialized in the laws governing insurance and have advised American and alien insurers, reinsurers, intermediaries and insurance consumers on a wide variety of matters.

I am flattered to have received an invitation to appear before you today to discuss ways to increase the capacity to underwrite commercial lines insurance in New Jersey. I hope that the observations I make will be of assistance to the Committee in coping with this most important subject.

As I am certain you are aware, New Jersey is not alone in suffering a dearth of insurance capacity. The phenomenon is national; no jurisdiction has escaped it. Some states have formulated legislative responses to the twin problems of insurance availability and affordability which appear to have ameliorated these problems. Others have taken ill-advised actions which have merely aggrevated the problem.

I believe that New Jersey can learn from the experiences of its sister states. I therefore propose to focus upon these experiences. I am not unmindful, however, of the list of proposed bills which were set forth in the

August 18 Notice of Public Hearing and I will comment upon these bills as well.

In investigating ways to increase capacity, one should first examine why there is a dearth of capacity. It is my considered opinion that capacity is lacking in certain lines of insurance because, quite simply, underwriters are unwilling to pledge their limited resources to writing New Jersey risks. Why is this so? I think that underwriters believe that they will lose money if they do so.

Now this belief may or may not be valid. Nevertheless, it exists, and I believe it is incumbant upon the legislative and regulatory authorities in New Jersey to change it.

How can you, as legislators, dispel the belief that certain New Jersey commercial risks can not or should not be underwritten? The first is to <u>listen</u> to the lament of insurers that they no longer can predict their losses in certain lines. The Supreme Court of New Jersey has a well-deserved reputation as one of the most anti-insurer courts in the United States. It is my understanding that very few policy wordings can survive adverse scrutiny by that court. Legislation designed to prevent judicial redrafting of insurance policies is therefore a prerequisite to developing a market in the lines affected. The recently

passed proposal (S. 1152 and 545) with respect to liquor liability and Senator Lesniak's bill concerning defining the term "sudden and accidental" (S.B. 2325) are commendable steps in the right direction.

Many of these proposals share a common characteristic: they constitute tort reforms. I am quite aware that some of you may not wish to hear pleas for tort reform, but I would be less than candid if I failed to state first and foremost that the most important legislation to increase capacity in New Jersey is significant tort reform.

Your sister states have found that the more comprehensive the tort reform enacted, the greater the likelihood that insurers will dedicate their limited capacity to that state's market and will underwrite risks in that state rather than in some other state. I understand that the tort reform legislation enacted in the states of Washington, Alaska, Colorado and Connecticut has had this effect. As a further example, the passage of Proposition 51 in California has resulted in a new found willingness of insurers to underwrite municipal liability insurance in that state.

Recently the National Conference of State Legislatures Legislative Information Services published a lengthy report which, inter alia, summarized state actions and initiatives in controlling liability insurance costs. This widely

circulated report compared the tort reform legislation enacted by all states through July 15, 1986. New Jersey, I must note, fared very poorly in comparison.

A further means of encouraging capacity is to avoid certain significant mistakes of your sister states. I do not think that mandatory rate rollbakcs will do you any good. They will merely result in insurers leaving the state. The reason for this is simple. Even at present premium rates insurers are suffering underwriting losses. Mandatory rate rollbacks can only aggrevate an already serious situation. While tort reform will most likely ease this situation in the future, the impact of mandatory state rollbacks is immediate and severe. Consequently, many insurers faced with such rollbacks believe the only feasible alternative is to stop writing business in that jurisdiction. Florida has seen this happen; Hawaii, which I understand has passed similar legislation, is likely to see it also. What good are mandatory rollbacks when there are no insurers willing to write the risks at all?

Another mistake is to mandate onerous rules governing cancellation and non-renewal of risks. I believe that the insured is entitled to know why he is being cancelled and/or non-renewed and to have the opportunity to replace his coverage. But if you go too far, you will lose the markets you have.

Insurers will not write new business. In particular, the distinction between the admitted market and the surplus lines market must be retained. Regulations which may be considered desirable for the admitted market's ordinary business should not be imposed upon the surplus lines market which is reserved and available for difficult and high-risk business. When the New Jersey Insurance Department's original cancellation and non-renewal regulations were imposed upon surplus lines insurers, the surplus lines market dried up. It did not return until the regulations were amended.

And this discussion of surplus lines raises another point -- the effect of the non-admitted market on capacity available to New Jersey insureds. New Jersey has a very unfortunate reputation among non-admitted or surplus lines insurers. Very few surplus lines insurers are eligible in New Jersey. The principal reason is the existence of a unique surplus lines guaranty fund which, in my view, is a fraud upon the public. For financial reasons well known to this Committee, it promises what it cannot deliver. In my opinion, its repeal is overdue. I commend Senator Di Francesco on his bill (S.B. 788) which would do so.

A second reason is the archaic surplus line law which has been in effect in New Jersey for over 25 years. Last year, at a time of vast expansion of surplus lines business

nationwide, New Jersey expanded only 57.6% from 1984 and only 28.7% from 1983, as compared to 133.5% and 171.9% for New York and 86.1% and 94.2% for Pennsylvania. I believe that a revision of New Jersey's surplus line law is essential. The National Association of Insurance Commissioners has labored long and hard in developing a model law which would be particularly beneficial to New Jersey. Promotion of the entry of strong surplus lines insurers into the New Jersey marketplace coupled with less regulation of these strong insurers should be the watchword. A healthy surplus lines marketplace is a precondition to the flexible capacity necessary to cope with periodic crises such as we are presently experiencing. Enactment of the N.A.I.C. model act coupled with an enlightened regulatory philosophy in the Insurance Department would greatly help alleviate the current crisis.

What else can you do? Government insurance or reinsurance has been touted by self-proclaimed consumer advocates as a possible cure. In the short run it would serve to replace non-existant private capacity. But at what cost to the taxpayers? If the private professional insurance industry is unable to see their way to write business at a profit, how can government which doesn't have any experience or expertise in this area do better? The history of government insurance programs has often been one of exclusivity

and/or subsidy. In short, governmental entry into the insurance marketplace as an insurer could prove to be a very costly exercise for New Jersey taxpayers and can only be counter productive in addressing and resolving the present capacity shortage.

Encouraging improved risk management through the formation of self-insuring mechanisms is an excellent idea. Every day we read of some group of former insureds which have opted for self-insurance. I think Senator Lesniak's reciprocal legislation is certainly one way to deal with this subject. Legislation, such as that enacted in Vermont and Hawaii, to encourage the formation of captive insurers is another way. I have a preference for mutual insurers. The reciprocal format can easily lead to abuses by the attorney-in-fact. New Jersey should consider encouraging its industries to form captive insurers in New Jersey with minimal regulations à la Vermont. The tax engine which motivated companies to flock to Bermuda and the Cayman Islands has been largely removed by the new tax reform act. New Jersey has an historic opportunity to take advantage of this tax law change and become the leading U.S. jurisdiction for captive insurers.

Another proposal which you may wish to consider is legislation which would encourage the purchase of property and casualty insurance on a group basis. New York law presently

does not permit the purchase of group property and liability insurance and has been advised by The Jones Commission that enactment of a law specifically permitting such purchases would alleviate the capacity problem. The theory underlying the Federal Risk Retention Act is to permit purchasing groups of similarly situated insureds to band together to obtain necessary coverage. New Jersey should encourage this proposal.

Similarly, New Jersey could encourage other insuring mechanisms to insure New Jersey risks. The New York, Illinois and Florida Insurance Exchanges have capacity that may be profitably utilized in New Jersey. A change in the surplus lines law to accommodate the unique features of these Exchanges would be necessary and I understand that Senator Cardinale has sponsored a bill which will do so. But care must be taken to insure the financial bona fides of these exchanges. Also, it should be noted that each Exchange, like Lloyd's, has its own security fund. I doubt if they are anxious, therefore, to come to a state which can also assess contributions to a surplus lines guaranty fund.

Finally, I would encourage you to listen to insurers who are advocating the permissive use of claims made insurance. I find it ironic that the New York Insurance Department, which has vehemently opposed the use of the ISO-CGL policy, has nonetheless supported legislation which mandates the

exclusive use of claims made policies for physicians and surgeons. I guess consistency is the hobgoblin of my little mind. The fact is that a claims made policy is easier to underwrite than an occurrence form because it vastly improves the underwriter's ability to perform his single most important function, i.e., to predict and price the likelihood of a covered loss. In addition, certain risks cannot be underwritten on an occurrence format - the insurers have been burned once too often. They cannot predict their losses and thus cannot price their product. The claims made form is not appropriate for every line of insurance and, to my knowledge, no one is so advocating. But it is appropriate for many commercial liability lines and its availability should be permitted. I understand that at least forty states have agreed to permit the claims made form. New York is being stubborn. There is no reason why New Jersey should follow its lead.

I appreciate the opportunity to speak to you today. If nothing else, I would like to leave you with this view: regulation for solvency is to my mind the critical function of government; where government attempts to replace the market in determining what is best for the consumer, artificial restrictions will result. The current capacity crisis will gradually work itself out; loosening unnecessary regulatory

restrictions can hasten its end. The heavy hand of government - in the form of ill-advised and unnecessary regulatory burdens - can only exacerbate it.

I will be pleased to attempt to answer any of your questions.

STATEMENT TO THE NEW JERSEY SENATE COMMITTEE ON
LABOR, INDUSTRY & PROFESSIONS

AUGUST 26, 1986

by: Peter Sweetland, President, New Jersey State
Medical Underwriters

112x

I appreciate the opportunity to speak with you today on the subject of "captive" insurance companies. Our company not only functions as New Jersey's doctor-owned malpractice insurer - we are also the administrator of the Physician Insurers Association of America, an organization of thirty-nine similar companies ranging from coast to coast and providing coverage for more than half the country's independent physicians. With ten years of successful operations virtually completed, the Medical Inter-Insurance Exchange - like many of its association counterparts - has proven that a special purpose captive insurer can be a part of the solution to problems such as we see today. My comments will highlight some of the features of this success. At the same time, however, I will be emphasizing the additional fact that captives alone cannot solve the problem. Better availability and some cost savings can be accomplished; but, so long as the continuing expansion of the present reparations system generates more claims and escalates the amounts paid in defense and settlement of those claims, captives just like their predecessors will be forced to continually raise rates or face financial impairment.

STRUCTURE

To begin, I should point out that the term "captive insuror" can be applied to a broad spectrum of organizational modes. Fundamentally, the description covers any insuring entity which includes its owner or owners as its primary client. Single corporations may own captives but they must be very large to do so and survive. Our company is a second version known as an association or group captive. The members of a group with a common insurance problem (in our case organized medicine) become both the policyholders and owners of the company. Over time, they share both the economics and the risks of the venture. I believe your interest in the subject today centers on group captives.

A second structural variation relates to the differing levels of capitalization, taxation and regulation possible. These are primarily a function of where the company is organized. The best known example is the offshore captive. Depending on the country selected, there is little or no outside control over forms, rates and the contingency reserves that the company decides to utilize. In the U.S., several states including Colorado and Vermont, encourage the formation of such companies by limiting the size of start-up capital and surplus and providing some tax preferences. Finally, any captive may be formed in its own state so long as existing rules are followed. Our company was established under New Jersey rules and is subject to the review of the State Department of Insurance.

While the use of a different venue is of significant value in avoiding the very time consuming regulatory process, I would caution strongly against taking this approach with a primary objective of minimizing the

company's start up capital. Requirements in this state are certainly low enough and, with the uncertainties of "long tail" general liability lines of insurance, they are probably too low. The Medical Inter-Insurance Exchange started with twenty times the specified minimum. The purpose of this capital and surplus fund is to provide a contingency reserve in the event rates for any period prove insufficient. We have had to use the fund for just this reason several times.

THE ADVANTAGES OF A CAPTIVE

As I have suggested, there are a number of real benefits from the formation of such a company. With policyholders as owners, any profits automatically flow back as savings. If the insureds are concerned that any given rate change may be too conservative, they can be satisfied that anything ultimately left over will be returned. At the same time, they have control over the company's day-to-day operations through elected board membership and committee input. In a company such as ours, the doctor involvement is not only substantial, it is essential. Physicians provide all the medical expertise necessary for our underwriting, claim, and loss prevention functions. This makes us far more proficient as a specialty insuror than our commerical counterparts.

This specialization also produces significant economies of operation. For example, with group sponsorship, a marketing force is not always necessary. We were able to start up with 60% of the state's doctors as members without having to pay agents commissions. This fact, coupled with real savings from extensive computerization, has enabled us to keep total in-house costs at 8% of premium. Traditionally, industry norms for such expenses have been 25-35%. Most all of the doctor owned captives in the country have been able to function for less than 15%.

Another significant plus can be found in the management of investments. With reserve funds isolated for a long tail line of coverage, true results can be measured and estimated in advance in the calculation of premiums. The portfolio can be structured conservatively in relation to payment forecasts yet full advantage of changing yields can be taken by altering maturities within that structure. In our rate calculations today, we reduce forecasted loss payments by 1/3 in anticipation of investment return. We have continually used conservative interest rate assumptions in this approach to avoid wide fluctuations in premium rates as yields have oscillated. Over our ten year history, returns have been better than published norms and they always have been used to the policyholder's benefit.

A final, very significant advantage of a captive is the enhanced ability to prevent losses. Direct involvement of insured members will provide the best possible insight in identifying preventable circumstances. Information gained in this analysis can be passed back through the

sponsoring organizations and the expectation of direct impact on future rates helps to motivate positive action. At the Exchange, we are continually evaluating loss information and converting it to positive instruction. Seminars have been held at the rate of one a week over the last two years. These presentations are usually made at hospitals. It is difficult to measure the exact impact of these efforts against the continually broadening types of allegation presented but it is certain results would have deteriorated further without this work.

DISADVANTAGES TO THE CAPTIVE APPROACH

The primary message I have to impart is the fact that the single existence of a captive doesn't make the problem go away if the loss trends are real. In our case, this is just what has happened. We have accomplished substantial expense savings and some measure of loss prevention in certain specialties. Rates were level for our first five years as a result. Now the underlying rate of increase in claim has caught up with those savings and rates have had to rise at an annual rate of 20% or more. The optimism surrounding the establishment of a captive often prompts the leadership to rationalize away sound forecasts of needed rate increases. The fundamentals cannot be ignored. Our experience has been that the best outside consulting advice we could get was usually too low when it came to estimating needed rates. If anything, we were saved by better than average investment performance and an adequate capital and surplus fund.

A second fundamental, which is often lost in the enthusiasm for policyholder owned companies, is the need to be large enough to spread the risk. Insurance only works when there are enough participants of a similar class to spread the impact of the individual large loss. This is particularly true in general liability where single payments are so large. No matter how clean a small group's experience has been in the past, one big verdict can wipe them out.

The traditional method of removing this risk of catastrophic loss, is the purchase of reinsurance. You have been advised already that this particular marketplace is in just as bad a condition as the primary carriers. When a small captive sets out to find reinsurance under these conditions, the coverage is either totally unavailable or priced so conservatively that the company is better off without it. Some small companies find that their reinsurers dictate their basic rates and policy forms and, in the process, the very self-determination which was sought in the establishment of the organization is lost.

In my judgment, a new company should generate at least $20 million in annual premiums to be viable at the start. Propsects of growth to the $50 million level should also exist in the not too distant future.

RESULTS OF NEW JERSEY'S DOCTOR-OWNED CAPTIVE

For many pessimists, the mere fact that the Medical Inter-Insurance Exchange is still around is an outstanding accomplishment. Not only are we still around, we have proven that we can do a superior job of managing this particular problem for organized medicine. Our objective was to function on a "break-even" basis and stabilize cost. While I conclude that we have broken even over the last 9½ years, my past comments have already disclosed that costs are not stabilized. If the average increase, used over that last three years continues for another three, rates will triple between 1984 and 1989. If interest rates continue to fall, the change will be even more severe. Countrywide the prognosis for other members of our association is the same with only few exceptions. The most notable exception is in California where meaningful tort reforms were passed in 1975. The results of those companies are uniformly superior to those of other states including ours.

In summary then, I strongly support the use of captive companies to insure difficult specialized problems. This only works, however, where the group is large enough and fiscal integrity is maintained. Even then, the insurance crisis will not disappear so long as the loss results are constantly fueled by the expanding concept of entitlement which we see today.

Thank you for providing the opportunity for me to speak with you today.

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STATEMENT OF MIKE SHAY

NEW JERSEY CITIZEN ACTION BOARD MEMBER

BEFORE THE

SENATE LABOR, INDUSTRY

AND PROFESSIONS COMMITTEE

August 26, 1986

117x

NJCA

Honorable Committee Members:

New Jersey Citizen Action is a coalition of approximately 100 groups: labor, non-profit, environmental, minority, senior citizens and tenants. We have been in the state four years working on problems ranging from unfair taxes to toxic waste. We go door to door talking to families and educating people on our issues. We have fourty-five staff members working at three offices in Hackensack, New Brunswick and Woodbury Heights.

The problem of skyrocketing insurance premiums and of the industry withdrawing from the market has created a state of crisis in New Jersey. Yes, there is an insurance crisis. National studies point out that insurance premiums eat up 11% of our disposable income. The difficulties facing New Jersey residents, businesses, non-profit organizations, municipalities and other entities is well-documented.

The cause of the crisis is also well-documented. The insurance crisis is a result of the cyclical nature of the industry. Insurers cut their prices when interest rates and thus their investment income is high. When interest rates are low, as they are now, investment income is low and "Panic Pricing" begins. It is this phenomenon that was responsible for the insurance crisis in 1976 and is responsible for the current crisis. The cyclical nature of the industry is well-documented. We bring it up again because it is important to understand as we discuss solutions to the crisis. The insurance industry is blaming the problem on injury victims. They argue that

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by enacting measures to eliminate our constitutional right to legal redress by strictly limiting (and in some cases eliminating) a victims right to sue for compensation, the liability problem would be stabalized. Fufilling this wish list of the insurance industry will not solve the insurance crisis. Reforming industry practices will.

To solve the current crisis in the property/casualty insurance market and to prevent future crisises the public, the insurance department and the legislators need to get the facts first.

Under present law, the public is in the dark about the amount insurance companies take in in premiums and pay out in claims for product liability insurance. The public is similarly unaware of how much insurance companies pay out for economic damages - i.e., actual out-of-pocket loss, such as medical expenses and lost wages; for compensatory non economic damages, such as compensation for paralysis, for the loss of a limb, for the loss of the ability to bear children or for brain damage; and for punitive damages - which are intended to punish the defendent and deter similar conduct in the future. Furthermore, the actual amount insurance companies pay out after a verdict is rendered (as apposed to the verdict which is most often much greater than the amount paid out), the amount they pay in settlements, the amount they pay to their own lawyers, and the amount of time that elapses between the time an insurance company receives notice of a claim and the time it actually pays the claim, are all facts that must be taken into acount when we seek to solve the insurance crisis. They are also all facts that insurance industry with holds from the public, the insurance department and

the legislators.

Today with liability insurance rates skyrocketing and insurance companies withdrawing from certain markets, and with different interest groups recommending widely-differing measures to bring down insurance rates, it is essential that policymakers have the above information.

In order to get the full picture the above mentioned facts must be broken down both by product line (i.e. drugs, machine-tools, cars, etc.) and company-by-company basis, for each of the last ten years and each following year.

Let the sun shine in on the insurance industry's books. You must not be forced to legislate in the dark. Demand the facts.

The current finanical disclosure bills in the Senate's package, S-2318 and S-2319 don't provide any of the necesary information. They perserve the status quo: no facts. After meeting with Citizen Action Senator Pallone has agreed to sponsor a REAL disclosure bill. We at Citizen Action urge the committee members to support and co-sponsor this bill which is currently being drafted. Drastic limmitations imposed on our civil rights through so called 'tort reform' is not appropriate before we get the facts. Let us get the information from the ones who have it - the insurance companies.

The same companies that (according to Bests 12/85) had an investment income of $19.7 billion in 1985. The same companies that (according to the Insurance Information Institute) realized a capital gain of $5.3 billion in '85. The same companies that the Government Acccounting Office estimates will realize a net gain in the next four years, before taxes, of $90 billion. These are the same

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companies that refuse to provide affordable insurance for day care centers, municipalities and pony rides.

We at New Jersey Citzen Action also request for public hearings with all the affected parties of the insurance crisis. Today's hearing was by invitation only, excluding many of the groups seriously affected by the crisis: non-profits, unions, church-groups and injury victims.

In conclusion, the insurance crisis will occur again and again unless measures are taken to examine the industry's accounting procedures. Line by line information on premiums collected and claims paid along with claims history of all line items needs to be available to the polciy makers and the public.

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INSURANCE INDUSTRY

FINANCIAL DISCLOSURE

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Under present law, the public is in the dark about the amount insurance companies take in in premiums and pay out in claims for product liability insurance. The public is similarly unaware of how much insurance companies pay out for economic damages - i.e., actual out-of-pocket loss, such as medical expenses and lost wages; for compensatory non-economic damages, such as compensation for paralysis, for the loss of a limb, for the loss of the ability to bear children or for brain damage; and for punitive damages - damages not to compensate the injured person but to punish the defendant and deter similar conduct in the future. The public is also unaware of how much insurance companies pay out after a verdict is rendered (as opposed to the amount of the verdict, which is often dramatically greater than the amount paid out) and the amount they pay out in settlements, the amount they pay to injured people and the amount they pay to their own lawyers and for expenses, and the amount of time that elapses between the time an insurance company receives notice of a claim and the time it actually pays the claim.

Today, however, with liability insurance rates skyrocketing and insurance companies withdrawing from certain markets, and with different interest groups recommending widely-differing measures to bring insurance rates down, it is essential that policymakers have the above information.

1. the amount paid out in economic damages, compensatory non-economic damages, and punitive damages, tabulated by size of economic damage;

2. the number of claims paid and the amount paid in claims pursuant to (a) verdicts (allocated separately for judge and jury verdicts); (b) settlements after a complaint is filed but before verdict; (c) settlements before a complaint is filed;

3. the total amount rendered in verdicts, and the tota amount actually paid out pursuant to verdicts;

4. the average time elapsed between receiving notice c a claim and payment of the claim, by size of claim paid;

5. the investment income earned on the amount ultimately paid between receiving notice of the claim and paying the claim, by size of claim paid;

6. the total amount paid in defense lawyer's fees in connection with claims paid (a) pursuant to verdict; (b) pursuant to settlements after a complaint is filed but befor verdict; (c) pursuant to settlement before a complaint is filed;

7. the total amount paid in defense lawyer's fees in connection with (a) defense verdicts; (b) claims resolved prior to verdict pursuant to which no indemnity was paid;

8. the total amount of all other loss adjustment expenses paid in connection with:

(a) claims paid pursuant to verdict;

(b) claims paid pursuant to settlements after a complaint is filed but before verdict;

(c) claims paid pursuant to settlements before a complaint is filed;

(d) defense verdicts;

(e) claims resolved prior to verdicts pursuant to which no indemnity was paid.

9. the total amount of premiums written;

10. the total amount of premiums earned;

11. the number of claims paid, and the total amount paid, arising from an occurrence in connection with which a claim was made against more than one defendant, and the amount by which that amount exceeded the amount proportional to the insurance company's insured's percentage of responsibility for the injury, as determined by the jury (in cases tried to verdict) or as estimated by the insurer (in cases that are settled).

The Committee believes that in order to fully present and analyze the impact of the Act on insurers the above data must be broken down both by product line (e.g., drugs, machine-tools, cars, etc.) and company-by-company basis, for each of the last ten years and each following year.

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1986 AMENDMENTS TO STATE RATING LAWS

COLORADO

Until recently, rates were not required to be filed with the Colorado Department of Insurance, with the exception of workers' compensation and employer's liability, medical malpractice, automobile assigned risk, and insurance written by captive insurance companies. The latter lines required prior approval. Effective July 1, 1986, a bill was enacted requiring that insurers must file rating information on all subsequent rate changes for all lines of business concurrent with the effective date of the rate change. These rate filings do not require the commissioner's approval.

CONNECTICUT

Connecticut enacted a law establishing a joint standing committee on insurance and real estate to study the process by which insurers establish rates and premiums for liability insurance coverage. The study will examine market influences, underwriting standards, investment income and its relation to the ratemaking process, reserving practices, and the claims made general liability policy form and systems for the classification of insureds. The committee will also evaluate the powers and duties of the insurance commissioner relative to the establishment of the rates and premiums, and will make specific recommendations regarding the advisability of a system of mandatory approval by the commissioner of any proposed change in rates and premiums or contract terms and conditions upon renewal by an insured of any liability insurance policy. Further, the committee is required to evaluate the feasibility of establishing a Consumer Advocate's Office within the insurance department and the possible effects that such an office would have on the insurance climate in the state.

A final report of the committee's findings and recommendations is due to the Governor and General Assembly on or before December, 1986.

IOWA

Iowa enacted a law requiring insurance companies to lower liability insurance premiums to reflect the reduction in annual losses caused by the enactment of the mandatory seat belt law. The commissioner is to determine the amount of reduction of the automobile liability insurance premium which is to take effect on all policies issued after July 1, 1987. In making this determination on the appropriate rate of reduction, the commissioner may employ the services of an actuary. The cost of these services shall be assessed against licensed insurers.

MARYLAND

Maryland is a "file and use" state for all lines of business except medical malpractice. However, its rating law permits the insurance commissioner, after hearing, to declare that a competitive market does not exist for a given line of business and thereby require prior approval for such line of business. To date in 1986 the commissioner has issued an order stating that the following lines of business do not possess a competitive market and that rate changes for these lines are subject to prior approval: public entity protection, day care facilities, lawyers professional liability, directors and officers liability, and busses other than school and church busses. The commissioner's order with regard to these lines will expire on May 6, 1987.

NEW YORK

New York has enacted flex-rating for commercial lines whereby the insurance superintendent establishes annual limitations governing commercial rate level increases or decreases which may take effect without prior approval. Filings which produce rate levels beyond limitations established by the superintendent require prior approval, except that filings shall be deemed approved unless disapproved within 30 days. Further, the superintendent may exempt a market from the rate limitations upon a determination that competition is sufficient and rates will not be excessive, inadequate, destructive of competition or detrimental to the solvency of insurers.

Within 90 days after the effective date of the statute, every insurer licensed to write property/casualty coverages in regard to a market not exempted by the superintendent must file with the superintendent rates appropriately modified to reflect the likely reductive cost effects reasonably attributable to any newly-enacted tort reforms. Filings are required to contain specific explanations of reductive cost effects in a form prescribed by the superintendent. The superintendent must determine whether rates filed reasonably reflect the likely reductive cost and if not, he shall state the basis for his determination. The affected insurer may thereafter request a hearing. Lastly, for purposes of the annual limitations, the rates determined to reasonably reflect the likely reductive cost effects shall be treated as if they had been in effect for the 12-month period prior to the date of such determination.

NORTH CAROLINA

North Carolina enacted two bills which alter the rating and classification plans and the ratemaking procedure for non-fleet private passenger motor vehicle insurance and permit the insurance commissioner to adopt a Safe Driver Insurance Plan. These bills also provide for the inclusion of public members on the Board of Governors of the Rate Bureau and its committees, as well as for reimbursement by the rate board for all insurance department rate hearing costs. Moreover, in the event the commissioner, after a rate hearing, disapproves a previously filed rate, the new law permits him to establish an interim rate. The commissioner may also require additional data from insurers on losses, investment income, administrative expenses and other data necessary to examine any line of insurance. In addition, the commissioner was granted authority to roll back rates to reflect 1986 modifications in North Carolina civil law.

OREGON

Oregon, a "file and use" state for commercial lines, recently changed its law to require prior approval for commercial rate changes increasing or decreasing rates by more than 25%. The law became effective on April 21, 1986.

VERMONT

Vermont's competitive rating law was recently amended to require the insurance commissioner to hold a hearing to determine whether a competitive market exists "whenever in any market over any 12-month period the average rate for all premiums in any line of insurance increase by 25% or more". Otherwise, the competitive market is presumed to exist.

WEST VIRGINIA

West Virginia has enacted a law requiring that rate filings for liability insurance for political subdivisions must be accompanied by information requested by the insurance commissioner so as to determine claims payouts, investment income, premium income, loss reserves, administrative expenses, profits, losses and other such pertinent information necessary to assess the profitability of such business. Liability coverage for political subdivisions may not be reduced without the written consent of the insured and the policy premium may not be increased by more than 10% per year.

The statute grants to the commissioner the authority to disapprove any casualty rate filing for failure to provide the required information.

WASHINGTON

Washington, a "file and use" state for commercial lines, has a deemer provision whereby rates become effective in 30 days unless disapproved by the Commissioner. A law has been enacted requiring the insurance commissioner, in reviewing a property/casualty rate filing, to determine whether the insurer should grant to the policyholder a credit in the rate filing. The rate filing may be disapproved if the commissioner finds that the rate is inadequate, excessive or unfairly discriminatory.

TEXAS COMMERCIAL LIABILITY INSURANCE UNIFORM CLAIMS REPORT

Exh. A

DRAFT

1. a) Name of Insurer

_____

b) Name of Insurer Group

_____

c) Claim File Identification

_____

d) Name of person completing form

_____

e) Telephone number

_____

2. a) Date of Injury

____/____/____
Month Day Year

b) Date Reported to Insurer

____/____/____
Month Day Year

c) Date Closed

____/____/____
Month Day Year

3. Age of injured person at time of injury _____

4. a) Was injured person employed at time of injury? 1___ Yes 2___ No

b) If yes, did injury occur in course of employment? 1___ Yes 2___ No

5. Type of Injury
1____ Wrongful death
2____ Other Bodily Injury

6. a) Policy Type
___ O L & T (All Forms)
___ M & C (All Forms)
___ Commercial Auto
___ Medical Malpractice-Hospitals

130x

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b) Business Class
1___ Governmental entities
2___ Schools (Public & Private)
3___ Daycare centers
4___ Liquor liability
5___ Non-profit organizations
6___ Construction firms
7___ Directors and Officers
8___ Other

c) Policy Limits (Bodily Injury)
Per Person

_____

Per Occurrence

_____

Aggregate Limit, if applicable and if known

_____

Combined Single Limit (if Applicable)

_____

7. a) State where injury occurred

1___ Texas 2___ Other

b) If Texas, give county where injury occurred _____

c) If Texas, give county where suit as filed _____

d) If Texas, give county where case was tried _____

8. a) Was an attorney involved for plaintiff? 1___ Yes 2___ No

b) Was an attorney involved for insurer? 1___ Yes 2___ No

9. a) Stage of legal system at which settlement was reached or award made:

1___ Binding Arbitration

2___ No Suit Filed

3___ Suit filed but settlement reached before trial

4___ During trial, but before court verdict

5___ Court verdict

6___ Settlement reached after verdict

7___ Settlement reached after appeal was filed

b) If a court verdict is indicated in a) above, indicate result:

1___ directed verdict for plaintiff

2___ directed verdict for defendant

3___ judgment not withstanding the verdict for the plaintiff

4___ judgment not withstanding the verdict for the defendant

5___ judgment for the plaintiff

6___ judgment for the defendant

7___ for plaintiff, after appeal

8___ for defendant, after appeal

9___ all others

c) If case did go to trial, was case tried by jury?

1___ Yes (by judge and jury)

2___ No (by judge alone)

10. a) Were there defendants other than your insured?

1___ Yes 2___ No

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b) If a) is yes, how many other defendants? _____

c) If a) is yes, indicate type of other defendants

1___ Individuals (Private)

2___ Individuals (Business)

3___ Partnerships, Corporations, or other business organizations

4___ Non-profit Organizations

5___ Governmental Entities

11. a) If case was tried to verdict, what percentage of fault was assigned to your insured?

_____

b) If claim was settled, estimate the percentage of fault for your insured:

_____

c) What percentage of final award or settlement was paid by you?

_____

12. Please indicate the following with respect to the total amount paid to claimant

a) Amount paid by you, the insurer

_____

b) Amount paid by insured, due to retention or deductible

_____

c) Amount paid by excess carrier

_____

d) Amount paid by insured due to settlement or award in excess of policy limits

_____

e) Amount paid by other defendants/contributors

_____

f) Total amount of settlement or award (a + b + c + d + e)

_____

13. Were collateral sources, such as medical insurance, disability insurance, social security disability, or workers' compensation, available to the injured party?

1____ Yes

2____ No

3____ Unknown

14. a) Was a structured settlement used in closing this claim?

1____ Yes 2____ No

b) If a) is yes, did structured settlement apply to plaintiff's attorney's fees as well as indemnity payments?

1____ Yes 2____ No

c) If a) is yes, indicate amount of immediate payment

_____

d) If a) is yes, indicate projected total future payout

_____

e) If a) is yes, indicate present value of projected total future payout (price of annuity if purchased)

_____

15. Injured person's medical expenses through date of closing

_____

16. Injured person's anticipated future medical expense

_____

17. Injured person's wage loss through date of closing

_____

18. Injured person's anticipated future wage loss

_____

19. Injured person's other expenses through date of closing

_____

134x

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20. Injured person's anticipated future other expenses

_____

21. Amount of non-economic compensatory damages

_____

22. a) Actual amount of prejudgment interest, if any, paid on award

_____

b) Estimated amount of prejudgement interest, if any, reflected in settlement

_____

23. a) What role did punitive damages play in this claim?

1___ Asked for in petition, no granted

2___ Asked for and granted by court or jury

3___ Asked for in settlement, not granted

4___ Asked for in settlement and paid by insurer

5___ Not applicable

b) If punitive damages were asked for, what was the amount?

_____

c) If punitive damages were actually awarded, what was the amount?

_____

d) If punitive damages were considered in settlement, estimate the amount.

_____

e) If punitive damages were paid by the insured, what was the amount?

_____

f) If punitive damages were paid by the insurer, what was the amount?

_____

24. a) Amount paid to outside defense counsel

b) Amount of other allocated loss adjustment expenses, such as court costs and stenographers fees

c) Total allocated loss adjustment expense (a + b)

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