



For Immediate Release
January 6, 2004

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Tillinghast's "Tort Cost" Figures Vastly Overstate the Cost of the American Legal System

Every year, an insurance industry-consulting firm, Tillinghast–Towers Perrin,¹ estimates what it calls the overall annual “cost” of the U.S. tort system. In its 2003 report, Tillinghast put this cost at \$233 billion.

To reach the estimate, Tillinghast does not examine jury verdicts, settlements, lawyers’ fees or any actual costs of what might generally be considered the legal system. Rather, Tillinghast’s numbers are calculated from total liability insurance premiums, primarily as reported by the insurance reporting firm, A.M. Best, as well as Tillinghast’s own “internal” sources. Had Tillinghast honestly measured tort system costs, these costs would have been lower, by at least 50 percent, because so much of what the company measures is not even vaguely related to the legal system.

Each year, consumer groups and many academics have criticized Tillinghast’s methodology.² Now, for the first time, Americans for Insurance Reform, a coalition of over 100 public interest groups from around the country, has provided a detailed analysis of why Tillinghast’s numbers are wrong, and are inappropriate for demonstrating either total costs of the U.S. tort system, or cost trends over time.

Tillinghast’s definition of “tort system costs” is incorrect. Tillinghast’s definition of tort system costs, and its most inflammatory finding (“the U.S. tort system is highly inefficient, returning less than 50 cents on the dollar to the people it is designed to help”), are calculated by *including the immense costs of operating the wasteful and inefficient insurance industry*. Fully 21 percent of so-called “tort” costs are what Tillinghast calls insurance industry “overhead” (e.g. salaries of executives, rent and utilities for insurance company headquarters, commission paid to agents, advertising and other acquisition costs). And on top of that, Tillinghast also includes costs like auto insurance liability claims for fender benders, for which policyholders pay insurance premiums, the vast majority of which are settled without any attorneys being hired or anyone being sued. It even appears to include auto medical payments coverage, auto no-fault insurance cases (where lawsuits are *prohibited* against third parties in most cases), and uninsured and underinsured motorist coverage, when claims are paid to the policyholder by his or her own insurance company.

Thus, Tillinghast’s analysis is of a system it calls the “tort” system, but which is, in fact, vastly larger than the actual tort system.

Tillinghast distorts the facts. Throughout the report, Tillinghast makes unfounded assumptions, adjusts figures without any basis, and fails to provide explanations or sources. On the rare occasion when it does provide “sources,” they include such impossible-to-verify citations as “internal Tillinghast Reviews,”³ “internal Tillinghast study,”⁴ “Tillinghast-Towers Perrin’s internal database,”⁵ “various studies published by Tillinghast and Conning & Company,”⁶ and “our best estimate.”⁷

For example, it attributes 21 percent of so-called “tort” costs to “administration,” or insurance industry “overhead.” As explained above, it is wrong to call this a “tort” cost, but also, the number itself is not verifiable.⁸ As another example, Tillinghast simply adds into its “estimate” of total tort costs an additional 32 percent (in 2002) of the expense of the entire liability insurance industry, to cover what it guesses to be “self- (un) insured” costs. While it is true that self-insurance is a growing percentage of the entire system, Tillinghast neither explains the basis of its estimates nor makes any adjustment to reflect the greater efficiencies of self-insurance programs. Tillinghast apparently assumes that the self-insurance system requires the same inefficient delivery system as the insurance industry, which is untrue. By using this device, Tillinghast overstates the costs of the tort system significantly.

A much more significant error is that nearly half of the “tort costs” identified in the report concern personal auto insurance. In 2002, net premiums earned for personal auto liability were \$82 billion.⁹ This represents an overwhelming 58 percent of what Tillinghast uses as the base for all of its calculations: \$141 billion in liability insurance premiums.¹⁰ Typical auto liability claims (such as fender-benders) are overwhelmingly settled without claimants’ hiring attorneys or suing anyone, and with a large portion of the claims paying for only the damage to the car. To count all the tiny scrapes of fenders as “tort costs,” as Tillinghast does, makes their study wholly unreliable.

It is remarkable that Tillinghast writes an article on the ups and downs of tort costs without even mentioning the well-known insurance cycle, which results in cost increases having nothing to do with the tort system. Insurance is a cyclical business. Its costs are cyclical as well. Three times in the last 30 years, insurance policyholders have experienced particularly large and sudden rate hikes. This is typical of what policyholders experience during the so-called “hard market” part of the insurance industry’s cycle. The cause of the hard market is always the same: a drop in investment income for insurers compounded by underpricing in prior years. When investment income drops, insurers always respond the same way: by reducing coverage, canceling policies and/or raising premiums, often dramatically. Since 2001, we have been in a “hard market” period, although this period is now ending.

During hard market periods, insurers typically will fix their balance sheet to show an increase in “reserves” to pay claims. The increases in reserves are not the result of actual increases in claims or payouts (e.g., lawsuits, jury verdicts or other tort system costs.) Rather, they are an accounting device used by insurers to make up for previous inadequacies in reserves, hide excessive profits and justify price increases.¹¹ (For more detailed explanation of how the insurance cycle works, see *Stable Losses/Unstable Rates*, Americans for Insurance Reform, November 20, 2003, <http://insurance-reform.org>.)

In conducting any evaluation of insurance industry costs, it is critical to take into consideration the insurance cycle and the accounting practice of overreserving during the hard market. Yet in this report, Tillinghast fails to mention it or even take note of the insurance cycle at all, even though it is the best explanation for many of the findings Tillinghast seeks to blame on rising tort costs.¹² This omission seems particularly conspicuous because in other publications, the company not only acknowledges the cycle, but also advises insurers on how to “ride” the cycle to maximize profit.¹³

If Tillinghast had simply adjusted its figures for medical inflation, it would have shown decreasing costs between 1990 and 2001, and an uptick only since the beginning of the hard market. Tillinghast adjusts its figures using the rate of general inflation, instead of the higher rate of medical inflation, which has the effect of making award costs appear to rise faster than they really have. This is odd, since the bulk of tort claim payouts are to cover injuries to people through recompensing them for their medical expenses. It is also odd because the report itself identifies the rate of inflation for medical costs (“Medical Care CPI”) in various tables in the report, but never uses that information to adjust dollar figures over time.¹⁴ If Tillinghast had done so, the changes in “Tort Cost per Citizen” would look much different, reflecting a drop in costs over the last twelve years, even using Tillinghast’s inappropriate definition of “tort costs:”

Year	Per-citizen tort costs, 2002 dollars (adjusted for CPI All Items) ¹⁵	Per-citizen tort costs, 2002 dollars (adjusted for CPI Medical Care ¹⁶)
1950	\$89	\$224
1960	183	382
1970	314	570
1980	410	716
1990	716	914
2000	668	702
2001	733	757
2002	809	809

Tillinghast does not measure the countervailing costs saved by the tort system; nor does it place any value on the rights granted to all Americans by the tort system itself. Any analysis of tort system costs must consider the countervailing benefits of the legal system, which pays people for real damages that must be repaid in some way. If someone is brain damaged, burned, or rendered paraplegic as a result of the misconduct of another but cannot obtain compensation from the culpable party through the tort system, he or she may be forced to turn elsewhere for compensation, such as to taxpayer-funded health and disability programs. In other words, the costs of injuries are not eliminated, but merely shift onto someone else, such as the taxpayer.

Moreover, the tort system provides the financial incentive for companies and institutions to act more safely. Tillinghast entirely ignores this point, failing to take into account the amount of money that the tort system *saves* the economy in terms of injuries and deaths that are prevented due to safer products and practices, wages not lost, health care expenses not incurred, and so on.

Finally, the right of injured people to sue and collect compensation from the perpetrators of their harm is one of the great achievements of American democracy. In our system, the poorest and most vulnerable, including those in need of medical care, the disrupted families of injured children or people who have suffered violations of their fundamental civil rights, can hold the largest wrongdoer accountable for causing harm. This is a precious and priceless right, the value of which Tillinghast entirely overlooks in this report.

In sum, while it is certainly worthwhile to undertake the difficult task of analyzing the actual costs of the legal system, Tillinghast certainly has not done that with its report, *U.S. Tort Costs: 2003 Update*. Its results exaggerate these costs by at least 50 percent and probably by far more than that. Policymakers and opinion leaders should consider these figures highly unreliable, and inappropriate for evaluating the costs of the U.S. tort system.

¹ In nearly every Tillinghast publication, except this one, Tillinghast describes itself as “a premier independent actuarial advisor to the insurance and financial services industry; our major clients include most of the world’s top insurers,” yet that description is conspicuously missing from the “U.S. Tort Costs” report. See, e.g., Tillinghast, *Enterprise Risk Management in the Insurance Industry: 2003 Benchmarking Survey Report*; Tillinghast, *2003 Stop Loss Survey*, at 7; Tillinghast, *Riding the Insurance Cycle, Part 2*, at 4; Tillinghast, *Update U.S.: Focus on Variable Annuity Market*, Sept. 2003, at 16.

² In a January 29, 1999 independent study prepared for the New York State Bar Association, Daniel Capra, Philip Reed Professor of Civil Justice Reform at Fordham University School of Law, called these figures “vastly overinclusive.” Ralph Nader noted in 1991 congressional testimony, “If consumer advocates came to Congress asking for a complete overhaul of the nation’s regulatory laws based on made up and mischaracterized numbers like these, we would rightfully be laughed out the door.” Committee on Commerce, Science and Transportation, Sept. 19, 1991.

³ Tillinghast, *U.S. Tort Costs: 2003 Update*, App. 4 note 3.

⁴ *Ibid.* App. 5 notes 2, 3, 4.

⁵ *Ibid.* at 16.

⁶ *Ibid.* App. 4 note 6.

⁷ *Ibid.* at 17 (The report states that “[n]o consistent historical database exists,” and “studies . . . typically have been limited to a particular state, coverage or exposure,” before stating the authors’ “best estimate.”)

⁸ See *ibid.* at 14 (The report provides no source, no basis for the figure, and no definition, but rather just states that “these costs are consistently defined and measurable over time.”)

⁹ *Bests’ Aggregates and Averages* (2003).

¹⁰ Tillinghast, *U.S. Tort Costs: 2003 Update*, App. 3.

¹¹ When insurers increase reserves, they also increase what are called “incurred losses.” Incurred losses are made up of actual paid losses *plus* the changes in reserves. In fact, the current hard market, or insurance “crisis,” rests significantly on a jump in loss reserves in 2001. Over-reserving is typical during hard market periods. Historically, reserves have been later “released” to profits during the “softer” market years. For example, according to a June 24, 2002, *Wall Street Journal* front page investigative article, St. Paul, which until 2001 had 20 percent of the national medical malpractice market, pulled out of the market after over-reserving during the last hard market and mismanaging its reserves. Christopher Oster and Rachel Zimmerman, “Insurers’ Missteps Helped Provoke Malpractice ‘Crisis,’” *Wall Street Journal*, June 24, 2002.

¹² For example, the report notes “tort cost growth experienced in 2001 and 2002 . . . akin to what was last experienced in the 1970s and 1980s,” but never points out that these are the three hard markets of the last 30 years, which explains the sharply rising premiums. Instead, the report goes on to list various alleged causes for the 2001-02 growth without any mention of the cycle. Tillinghast, *U.S. Tort Costs: 2003 Update*, at 3.

¹³ Tillinghast, *Riding the Insurance Cycle, Parts 1 and 2*, available at <http://www.tillinghast.com/tillinghast/publications/asp/regionpubs.asp?region=NA>.

¹⁴ Tillinghast, *U.S. Tort Costs: 2003 Update*, at 20, App. 1a, App. 1b.

¹⁵ *Ibid.* at 11.

¹⁶ Stated, but never used, in Tillinghast, *U.S. Tort Costs: 2003 Update*, at 20, App. 1a, App. 1b.