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CARS AND ACCIDENTS (II): SOME PROBLEMS WITH CIVIL LIABILITY INSURANCE FOR AUTOMOBILES

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• Introduction

One of the main features of the legal field of damages caused by motor vehicles is the vital presence of civil liability insurance taken out by the vehicle owner to cover potential compensation claims against whoever drives it.

In fact, civil liability insurers are the main agents in the administration (encompassing claim, processing and payment, both legal and non-legal) of damages deriving from traffic accidents. Moreover, the defendants in compensation claims brought by the victims of damages caused by motor vehicles are, in the vast majority of cases, the companies insuring the vehicles involved.

Without a doubt, this is helped along by the direct action generally attributed to the aggrieved party by articles 76 of the “Ley de Contrato de Seguro” (insurance contract law) and 117 of the penal code and, specifically for traffic accidents, article 6 of the “Ley de Responsabilidad Civil y Seguro en la Circulación de Vehículos a Motor” (law on civil liability and insurance for motor vehicles).

Article 76 of the insurance contract law stipulates:

"The aggrieved party or his or her heirs shall be able to take direct action against the insurer to demand that all obligations over compensation are fulfilled,..."

And according to article 117 of the penal code:

"Insurers that have taken on the risk of pecuniary liability deriving from the use of any property, company, industry or activity, when, as a result of a circumstance provided for in this Code, an event occurs that produces the insured risk, they shall hold direct civil liability up to the legally established or generally agreed compensation limit,..."

Finally, article 6 of the law on civil liability and insurance for motor vehicles, states the following:

"The insurer, within the domain of compulsory insurance, must pay the aggrieved party the sum of the damages suffered by their person or property, to then be charged to this compulsory insurance. The aggrieved party or his or her heirs shall have direct action to demand this."

• The effects of civil liability insurance on drivers' conduct

It is well known that art. 2 of the Spanish law on civil liability and insurance for motor vehicles imposes on the owner of any vehicle the obligation to take out an insurance policy that will cover civil liabilities deriving from use of the vehicle:

"Any motor vehicle owner who usually keeps his or her vehicle in Spain is obliged to sign an insurance contract for each vehicle owned. This shall cover the civil liability referred to in article 1, up to the sum of the compulsory insurance limit."

Even in the absence of this legal restriction, however, it is to be expected that a good number of citizens with motor vehicles would request insurance cover anyway, in order to be able to meet any compensation claims that may arise. What are the reasons behind this demand for insurance?

1.- The answer can be found in the economic theory of attitudes to risk. Someone who is averse to risk and facing the uncertainty that an unwanted event may take place, is in principle willing to pay to rid themselves of this risk, transferring it over to someone else who will not suffer any particular disadvantage from facing this uncertain event. For most vehicle owners, the risk of causing an accident and being forced to pay damages constitutes a risk that they would prefer to avoid, even if it means paying a premium (equal to or even higher than the expected value of the undesirable, unknown event) to whoever assumes this risk.

2.- This does not mean that liability insurance doesn't have other objectives, as well as that of transferring risk from someone who is averse to it to someone who is neutral. For example, even if the potential damage causer is not averse to risk, compulsory civil liability insurance can be an attractive option if he or she has limited solvency (which reduces the incentive to take proper precautions) and the insurer can reasonably control the insured's abidance by precautionary measures. Ultimately, the compulsory nature of civil liability insurance in these circumstances is a way of using the insurance companies as agents that control public safety, virtually a type of privatized law enforcement. This may be the case for environmental hazards within corporations: see Peter J. JOST *Limited Liability and the Requirement to Purchase Insurance*, 16 Int. Rev. L. & Econ., 259 (1996). In the case of traffic accidents, however, it seems clear that the justification lies in drivers' aversion to risk.

However, civil liability insurance (as with other forms of insurance), comes up against particularly serious difficulties in the sphere of traffic accidents.

The main one is what is known in economic theory as "moral hazard": if the insured party can, with his conduct, influence the likelihood that the accident stipulated in his insurance policy occurs, the very fact of being covered by insurance has a negative effect on his incentive to reduce this likelihood. A driver who knows himself to be covered by insurance for payment of compensation for any damages he causes, has less incentive than an uninsured person to take steps to reduce the likelihood of an accident, at least those accidents that will not affect his own physical well-being.

Yet the moral hazard obstacle can be overcome. The insurer can resort to various methods to mitigate it [Steven SHAVELL, *Economic Analysis of Accident Law*, Harvard University Press, Massachusetts (1987), 210 and ff; Gary T. SCHWARTZ, *Insurance, Deterrence and Liability*, *The New Palgrave Dictionary of Economics and the Law*, V. II, 336-337 (1998)]:

- If the insurer can observe, *ex ante*, the degree of precaution taken by the potential causer and make the insurance depend on the policy holder bringing his precaution up to the level of diligence required by both society and the law, the problem fades away. Unfortunately, this solution is rarely feasible (although it is partially viable in those cases where care essentially consists of a fixed capital investment that cannot be withdrawn or neutralized, such as an anti-pollution filter) and is never so in the domain of traffic accidents.
- Precaution may not be observable *ex ante*, before the accident, but still verifiable *a posteriori* once the damage has taken place, at least in certain circumstances: the car that has not passed the compulsory vehicle inspection causes an accident and is then found to lack the necessary papers; the intoxicated driver who causes an accident and subsequently tests positive for blood alcohol. In both cases, at least in the internal insurer-insured relationship, the Company would not take on the cost of damages caused. Some of the rules over the insurer's right to take action for recovery against the insured, as laid down in art. 7 of the law on civil liability and motor vehicle insurance, refer specifically to this eventuality.
- Partial cover or the application of minimum excess waivers are equally viable solutions, albeit incomplete ones, for the problem of moral hazard. In practice, they are rarely used in civil liability insurance for automobiles. Yet they are widespread in the various branches of damage insurance – including those of the automobile sector.
- By contrast, what is common today is the insurers' analysis of the insured's accident record in order to calculate the driver's civil liability premium. To have some effect on drivers' care, the incentive to avoid compensation payments, or at least reduce the expected compensation, is replaced by the incentive to pay a lower premium or avoid a higher one the following year. In extreme cases, if the premium has been raised enough, the incentive may even be to stop driving, as the company is not willing to insure civil liability at a reasonable price (or to drive without insurance, if the administrative and criminal sanctions are not sufficiently dissuasive).

Obviously, the predictive value of an accident record in calculating the risk that an individual driver supposes for the insurance company is neither uniform nor foolproof. For example, the more inherently dangerous an activity is (i.e., the greater the likelihood of harm even when due care is taken) or the more unusual the event causing harm actually is,

the less predictive value an accident record will have. Its use in civil liability deriving from car accidents, though, does seem totally justifiable: maybe not as much as in others, in which prediction is easier (work accidents or environmental accidents in corporations), but still more justifiable than in other forms of liability (malpractice by an individual doctor, as opposed to the public health service as a whole or a particular hospital).

However, it is difficult to imagine that moral hazard could be completely eliminated from civil liability for automobiles. This means that the level of drivers' precaution and therefore the damages that can be expected from traffic accidents are negatively affected by civil liability insurance.

• **Do we want civil liability insurance for automobiles?**

Civil liability insurance is not, however, socially undesirable as a result of the effect described above. The following section deals with some of the potential advantages of civil liability insurance in relation to problems deriving from limited solvency or insolvency of accident causers. What is important to highlight is that the foreseeable reduction of incentives to drive carefully is not sufficient reason *per se* to argue that civil liability insurance is inefficient. If, hypothetically, we suppose that victims are fully compensated for damages suffered (the principle of complete recovery) and given that, by definition, the insurer and the insured improve their position by agreeing to transfer risk through civil liability insurance, this leads to improved social well-being (technically, it brings about a Pareto-superior change, that is, it won't worsen anyone's financial situation and it will improve the welfare of at least one person).

Without a doubt, the full compensation supposition doesn't reflect the reality of how the legal system works. But neither is the increase in the probability of accidents that might result from civil liability insurance an unsolvable problem: criminal or administrative sanctions can help to mitigate the increase in accidents.

For example, potential victims are obviously not indifferent to an increased likelihood of fatal accidents. The same occurs in other cases that might cause moral damages to direct or indirect victims: economic theory actually tells us that these damages should not in principle be compensated ([Daño moral](#)). In other words, if civil liability insurance leads to an increase in accidents, this insurance is to the detriment of potential victims and its social desirability is problematic. But the automatic response should not be to ban civil liability insurance. The state and the legal system have other mechanisms that are, at least in theory, able to take accident probability rates to the same levels as would exist if there was no civil liability insurance. The use of administrative and criminal sanctions to punish drivers' negligent conduct can achieve this result, without at the same time sacrificing the efficiency gains of transferring the risk of paying compensation from risk-averse drivers to the insurance companies. This gain is particularly noticeable in relatively dangerous and socially widespread activities such as driving motor vehicles.

Moreover, if one takes into account the problem of drivers' limited solvency (which is analyzed more closely in the next section), the solution of banning civil liability insurance becomes even less appealing in the face of its direct opposite, that is, making this insurance mandatory: if we suppose that the level of damages is fixed and that compulsory insurance provides cover that is at least equal to the difference between the damage and the driver's solvency ($Cover \geq Damage - Solvency$), the level of drivers' care won't be below what would exist in the absence of insurance [Mattias POLBORN, *Mandatory Insurance and the Judgement Proof Problem*, 18 Int. Rev. of L. & Econ. 143 (1998)]. So, even though the victims are not indifferent to accident rates, the victims with compulsory insurance are no worse off than those who have been denied it – and drivers who are averse to risk would be better off, of course.

However, when explaining my reasoning above, my intention was not to defend the efficiency of civil liability at all costs. In fact, when the negative effect on risk reduction incentives is very strong and not easily neutralized by other means, it may be advisable, as a legal policy option, to ban civil liability insurance, as occurs with criminal pecuniary sanctions, which are not insurable. The importance of this argument lies in the way it highlights the interdependency between the level of compensation for aggrieved parties and the functioning of civil liability insurance. The greater the part of the damages suffered that is left uncompensated, the less desirable civil liability insurance is. And, in turn, the negative consequences of under-compensation of damages [see Pablo SALVADOR and Juan Antonio RUIZ, "Problemas de la responsabilidad civil en Derecho español", *Europa e Diritto privato*, n° 433 (1999)] will be magnified in an area in which, either through legal imposition or social demand, civil liability insurance is common: the increase in the likelihood of accidents implied in this insurance reinforces the distortion of prevention and compensation that occurs in an under-compensating civil liability system.

Although there is not yet any empirical evidence of any significance, almost no-one doubts that Spanish Tort Law patently under-compensates. With respect to traffic accidents, the phenomenon is even more worrying, for the reasons given above. And if the much-awaited studies on personal injury assessment schedules conclude that the schedule reinforces the under-compensatory nature of the system, this concern would grow noticeably (study introduced by Law 30/1995, of 8th November, on "Ordenación y Supervisión de los Seguros Privados" as an appendix to the law on "Responsabilidad civil y Seguro en la Circulación de Vehículos a Motor") ([Baremos](#)).

• Drivers' insolvency and care and insurance incentives

If car owners' aversion to risk is in itself enough to generate widespread demand for civil liability insurance for automobiles, what is the point of imposing a legal obligation to take out this insurance?

The answer can be found in the insolvency or limited solvency of a considerable number of potential damage causers and by the negative effects that this has on prevention, insurance and compensation for victims.

If all automobile owners had enough capital resources to face the highest compensation that could derive from a traffic accident, it would be totally redundant to make civil liability insurance for cars compulsory (although there would still be a demand for insurance by risk-averse car owners). The same thing would happen if the state could efficiently restrict the use of vehicles to those with sufficient solvency.

The first possibility is illusory. The second is socially unjustifiable. This means that it is necessary, as a fact of life, to have a certain percentage of drivers without sufficient capital to cover the damages they cause. But how does this affect drivers' conduct?

1.- In practice, limited solvency operates as an upper limit on the damage which could potentially be caused, a ceiling for expected compensation. The driver is thus inclined to take less care than he should in terms of the damage that could result from his driving. In addition, by not being able to afford the real social cost of his activity (as he can cause damages exceeding his solvency and not bear the costs individually), his decision whether to drive a vehicle or not, and how he does so, is not correct from the point of view of social well-being. All this naturally assumes that the amount of driving someone does, independently of the care that he or she takes at the wheel, is a factor that affects the likelihood of causing a traffic accident. This supposition seems perfectly reasonable.

2.- Neither would a risk-averse driver have enough incentive to purchase insurance. Given that his resources are less than the damages he might cause, part of the premium paid to the insurer will be used to pay for covering a portion of the liability that the driver, because of his limited solvency, would not have to pay for. Indeed, below a certain level of solvency, the driver would opt for not taking out civil liability insurance at all, and would prefer to take on the risk (limited, of course, because of his low solvency) of paying the victim's compensation. And this would be in spite of the fact that, because he is averse to risk, it would be better to transfer it to an insurer through an insurance contract.

The key work on the effects of insolvency is that of Steven SHAVELL, *The Judgement Proof Problem*, 6 Int. Rev. L. & Econ., 45 (1986) [included and extended in SHAVELL, *Economic Analysis of Accident Law*, cit., 240 and ff.].

3.- Finally, it is clear that the insolvency of the person responsible has a negative effect on the victims' chances of compensation. In fact, this effect is usually the one that is most emphasized by legal doctrine as grounds for making civil liability insurance for automobiles mandatory. From an analytical perspective, however, it is no more serious than the previous ones. Moreover, it would be the least relevant if one supposes that there are social safety mechanisms that at least partially cover misfortunes, be they traffic-related or otherwise, or that potential victims can be

obliged to take out insurance against traffic accidents: SHAVELL, *Economic Analysis of Accident Law*, cit., 243.

This last scenario seems rather unrealistic. The accident insurance policies found on the market either cover against generic risks – sickness or accidents of any kind – or against specific risks within equally specific activities – accident insurance for sports activities, for example. A type of insurance such as the one suggested by SHAVELL would provide solid insurance against a specific risk – traffic accidents – but one that might occur in a wide range of victim's activities – as a pedestrian, morning jogger, door-to-door salesman, housewife out shopping. It wouldn't fit into any of the existing markets and the transaction costs deriving from its purchase would probably be high, which would seem to suggest that social insurance is better in this domain. In addition, a measure that would make potential victims bear the costs of these accidents is difficult to justify politically.

• The compulsory nature of car insurance

There are several possible theoretical solutions to the negative consequences deriving from the limited solvency of those whose activity poses a risk for others. For traffic accidents, the solution that is almost universally adopted by legal systems consists in obliging potential damage causers to purchase an insurance policy that covers their civil liability – at least up to a relatively high sum – prior to starting the activity (in this case, using a motor vehicle).

There are other conceptually possible solutions that might help to mitigate the problem (for example, setting a damage threshold – not expected damage but actual damage – below which the injurer is not answerable, and above which the injurer loses all his capital resources), although his material prerequisites (stochastic harms with continuous probability distribution, heterogeneity of causers in relation to this distribution, etc) and/or economic prerequisites (contractual relationship between potential injurers with other people's "deep pockets"), does not seem to fit the area of traffic accidents easily and consistently. For two very recent articles that apply these theoretical solutions to the case of continuous environmental damages, see: Robert INNES, *Optimal Liability With Stochastic Harms, Judgement-Proof Injurers and Asymmetric Information*, 19 Int. Rev. L. & Econ., 181 (1999) & Tracy LEWIS & David E.M. SAPPINGTON, *Using Decoupling and Deep Pockets to Mitigate Judgement-Proof Problems*, 19 Int. Rev. L. & Econ., 275 (1999).

Mandatory civil liability insurance is by no means a panacea, but it does offer certain undeniable advantages.

- 1.- By definition, it eliminates the inefficiencies of insufficient insurance by risk-averse drivers.
- 2.- In addition, it greatly reduces the risks of total non-payment of compensation for victims – even more so if, as occurs in Spain, a cover system is introduced through the *Consortio de Compensación de Seguros* (Insurance Compensation Consortium) for victims of drivers who have breached the obligation to purchase insurance.

3.- Moreover, if one works on the assumption that mandatory insurance can, in practice, be regarded as comprehensive cover of the potential harm, one eliminates the possibility of unsuitable decisions as to whether to carry out the dangerous activity or not and to what extent, at least if one supposes that insurance premiums can depend on the degree of the activity (although perfect dependence in this sense is not very plausible, it does seem clear that the degree of activity is more easily observable for insurers, *ex ante* and *ex post*, and can therefore have a stronger influence on policy prices).

However, the problems of moral hazard mentioned in the previous section do not simply disappear or decrease just because insurance is compulsory, as its mandatory nature does not affect the insurer's ability to influence or control the degree of care taken by the policy holders. In fact, it can be proven that if insurers have absolutely no control over moral hazard, mandatory civil liability insurance will even reduce the care taken by drivers in relation to the already (inefficiently) low levels of care that arise under limited solvency. It will lead to a lower level of care than there would be with insurance (partial, given the limited solvency) that is freely chosen by drivers or when civil liability insurance is banned. On this, see SHAVELL, *On the Social Function and the Regulation of Liability Insurance*, Working Paper 278, Center for Law, Economics and Business, Harvard Law School, 20 (2000). Even if there is an absolute legal requirement for insurance, in other words, mandatory insurance must cover the maximum harm resulting from the activity, the level of care that an over-insured driver would choose to take would in fact be zero.

This would lead us to conclude that compulsory insurance with $\text{Cover} \geq \text{Maximum damage} - \text{level of solvency}$ is always in theory superior to one that requires $\text{Cover} = \text{Maximum damage}$. A system of compulsory insurance of the first type, though, would be more costly to manage.

All this in no way allows us to form an overall negative judgment of compulsory civil liability insurance for automobiles. One must weigh up its benefits, in terms of victim compensation and risk transference, and compare them to the relative costs and benefits of the alternatives to hand.

Although there is no empirical research on the issue, my intuition tells me that, most probably, the gains in efficiency deriving from mandatory insurance far outweigh its potential disadvantages. This does not mean that we can overlook the serious inefficiencies that arise from moral hazard, especially those associated to under-compensation of damages.