

To Our Clients and Friends

The last edition of our Corporate Governance Newsletter focused on the topic of “noise” in corporate decision-making and the role that governance processes can play in mitigating the impact of noise.

What is “Social Inflation”?

Social inflation refers to all the ways in which insurers’ claim costs rise over and above general economic inflation, including shifts in societal preferences over who should bear certain risks. More narrowly defined, social inflation refers to the legislative and litigation developments that affect insurers’ legal liabilities and claim costs. Social inflation is not a new term. Warren Buffett is often credited with coining the term in 1977 in his annual chairman’s letter to Berkshire Hathaway stockholders, where he warned that costs in the insurance sector were expected to rise. One explanation he offered was “social inflation,” which he described as “a broadening definition by society and juries of what is covered by insurance policies.”

Social inflation historically has occurred in waves and in response to the change in the liability landscape.

Nuclear Verdicts

Social inflation is primarily driven by what have become known as “nuclear verdicts” (generally those above \$10 million). A decade ago, there were multimillion-dollar verdicts across the United States, but now the top verdicts are measured in the billions of dollars. These jury awards are “nuclear” in the sense that such a verdict can have a devastating impact on businesses, entire industries and society at large, and are difficult to predict. According to a recent study by

This month, we are going to discuss social inflation, the impact it has on the industry, what can be done to combat it effectively and how the effects of social inflation factor into corporate governance.

For example, social inflation has notably affected product liability insurers, along with insurers of professional and medical malpractice. Recently, social inflation has erupted again as a disruptive issue for companies and their insurers. While social inflation is difficult to measure, some say that it is five to six times greater than economic inflation. Social inflation does not affect all business lines and is generally concentrated in such areas as commercial auto, medical malpractice, directors and officers (“D&O”) and in the umbrella and excess liability arena, especially when those policies cover large corporate risk (where the highest limits tend to be offered). Social inflation is also not limited to the United States. For example, class action securities litigation has become more common in Australia and an increasing number of D&O claims are being filed in response.

the U.S. Chamber of Commerce, nuclear verdicts are increasing in both amount and frequency. The median nuclear verdict increased 27.5% from 2010 to 2019, far outpacing inflation, and there was a clear upward trend in the frequency of nuclear verdicts over time. The majority of nuclear verdicts are produced by juries in six states—California, Florida, New York, Texas, Pennsylvania, and Illinois.

Causes of Social Inflation

Multiple factors are driving these nuclear verdicts, including jurors' anti-corporate sentiments and the perception that insurers are deep-pocketed; innovative tactics by the plaintiffs' bar; and the rollbacks in tort reforms.

Factors often pointed to as drivers of social inflation include: increased distrust of corporate America following the 2008 financial crisis; juries frequently sympathizing with plaintiffs and often believing that someone needs to pay when there is injury sustained, regardless of who was negligent; jurors no longer believing that corporations are the pillars of the economy; and jurors believing that significant monetary awards should be the rule rather than the exception. The common rationale is that the companies involved in the cases, including insurance companies, have deep pockets that can well afford to pay for pain and suffering.

Media outlets and particularly social media have exacerbated this sentiment. Opinions can easily be shared on social media and can affect how people feel about certain issues. Similarly, the public has become desensitized to the value and the perception of money. Whether it is a celebrity or CEO's annual income, reading about a social media influencer making millions of dollars by posting videos on TikTok, or seeing recent lottery jackpots in the billions, the concept of the "value of money" has become abstract.

The plaintiffs' bar has been successful in obtaining nuclear verdicts through strategies advanced both outside and inside the court room. Outside the courtroom, the plaintiffs' bar has become incredibly well organized and funded to engage in multiyear lawsuits. The plaintiffs' bar is now seen as a sophisticated, collegial and cooperative group. They work together as co-counsel and share information and witnesses. Part of this stems from their compensation structure where they may collect a contingency fee of 25-35% of the verdict or settlement.

Outside the courtroom, the use of advertising and litigation funding has dramatically altered the landscape. The increase in advertising is contributing to more litigation, particularly class actions. Advertising allows the plaintiffs' bar to identify better plaintiffs, encourage whistleblowers/future plaintiffs

to come forward, and publicize large verdicts in order to shape potential jurors' views of appropriate compensation. Litigation funding is also considered a contributor to social inflation and a driver of large verdicts. There has been a rollback in regulation that traditionally prohibited this arrangement. In a litigation funding arrangement, there is a third party providing capital to support a lawsuit. The third party's interest is purely financial. Resources from investors can fund cases for far longer than might be possible without the funding and investors might be reluctant to settle for amounts they do not feel are large enough.

The plaintiffs' bar has also adjusted its strategies inside the courtroom. As discussed above, the plaintiffs' bar has utilized the anti-corporation sentiment and lack of any conception of money to its advantage. Their arguments are rooted in creating an emotional reaction from jurors. The so-called "reptile theory" used by plaintiffs' attorneys can sway jurors to award extremely high amounts. This approach is an attempt to get jurors to view the corporation as not just having liability for the compensatory damages of the individual, but somehow having fundamentally failed to keep us safe. The reptile approach taps into jurors' anger and empathy and is meant to send a message that a large compensatory award is appropriate and that it is the jury's job to "send a message" to the alleged wrongdoer.

When it comes to damages, the plaintiffs' bar has utilized several different tactics to generate large verdicts. For example, "phantom damages" and "anchoring" are two large contributors. Phantom damages are the difference between medical costs billed and medical bills paid. Hospital bills have skyrocketed over the last decade because of advancement in medical treatments. Plaintiffs are now surviving injuries that they would not have in years past. In many cases, the difference is significant and what is billed is what is presented to the jury and the plaintiff and plaintiffs' attorneys profit from the difference. Because phantom damages are allowed in a majority of states, loss costs for insurers are inflated. Anchoring is a technique where the plaintiff's attorney asks for a court award above and beyond what has been traditionally thought reasonable for the alleged wrongdoing. This practice is highly

effective for creating large verdicts because it offers the jury a strong baseline for jurors struggling to value the case.

Finally, there have been a series of changes to legislation and case law that have eroded statutory tort reforms and advanced plaintiffs' interests. For example, some states have passed legislation to extend the statute of limitations and retroactively applied the

new time limit for certain causes of action. In some states, the caps on non-economic damages have been overturned by courts as unconstitutional.

Whatever the cause, nuclear verdicts increase claim costs and threaten the affordability of insurance coverage, but the industry can take certain actions to help reduce social inflation.

What Can Be Done to Combat Social Inflation?

There are multiple causes of nuclear verdicts and there is not a single solution. The insurance industry can counter the organized plaintiffs' bar with strategy forums of its own that produce a unified message on how to avoid the potential for nuclear awards. The forums can be made up of an insurer, legal counsel and a large customer, with the objective of determining the best way to defend lawsuits and avoid the internecine arguments that often erupt among stakeholders in excess liability towers.

The industry can also engage in the public policy debate to promote legislative changes to ensure fairness and financial reasonableness in settlement awards. Tort reform will likely be more successful by being able to point to social inflation developments and frame the impact on the industry in terms of pricing and availability. The industry can, for instance, lobby for regulation to address litigation funding, anchoring, and phantom damages.

Changes in the law will not be sufficient to contain social inflation. Companies and insurers need to be better at defending liability claims. Insurers can take advantage of new technology and advanced data analytics to develop predictive tools to litigate or settle claims, evaluate potential fraud and assess which lawyers to use before proceeding in a specific jurisdiction. Defense attorneys and their clients can alter their strategy and get better at defending against aggressive and increasingly well-armed plaintiffs' attorneys. Clients can resolve not to settle the case prematurely. Together, they can develop alternative narratives that allow the jury to identify with the defendant's position and counter social

inflation bias. That might include accepting some responsibility and offering a figure to combat plaintiff's anchor number. Further, greater use of jury consultants and mock juries—and presenting evidence in a way that counters societal numbness to large verdicts—may help bring down social inflation.

The insurance industry needs to track the overall changes in the liability landscape due to social inflation. This includes modifying underwriting to reduce opportunities for claims surprises. Insurers need to establish better early detection systems to draw on information from across their organizations, liabilities of their competitors, and from digital media.

Additionally, the industry could develop products focused on mitigating social inflation. For example, moving away from “all risk” type policies toward “named perils” policies. Given the potential liability exposure, co-participating agreements that help share the risk among reinsurers could help expand the confines of insurability. Parametric insurance might also need to be considered as another option.

Social inflation is nothing new, but it has grown rapidly over the last decade. The plaintiffs' bar has become particularly adept at marshaling social inflation for its own benefit, but there are steps the insurance industry can take to limit its effect. Whether through legislation, coordination with the defense team, or trial strategy, the insurance industry has opportunities to deflate the plaintiffs' bar's tactics and ensure that if there must be a plaintiff's verdict, it will at least be reasonable and rationally related to the harm caused.

Social Inflation and Corporate Governance

All insurance companies are at risk from social inflation. As part of the Board's oversight responsibility, it is important that there is an understanding of how this latent risk may impact the company in unexpected ways. By its nature, that impact is impossible to predict in a specific way (exactly what nuclear verdict will impact the company, where and when?). It is prudent, though,

for insurance companies to keep the risk of social inflation in mind as they develop strategy and assess overall corporate risk, to design processes for reporting out on situations that seem to give rise to the risk of a nuclear verdict, and to proactively develop corporate strategies, as described above, designed to counter the impact of social inflation.



Eric Dinallo
Partner
+ 1 212 909 6565
edinallo@debevoise.com



Nicholas F. Potter
Partner
+ 1 212 909 6459
nfpotter@debevoise.com



Michael W. Gramer
Associate
+ 1 212 909 6898
mwgramer@debevoise.com