Liability Costs for Small Business

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Summary

Legal reform – the battle to rein in runaway litigation costs – is often portrayed as a fight solely between large business and the plaintiffs' bar. In fact, lawsuit abuse affects *every* business and *every* American.

The U.S. Chamber Institute for Legal Reform commissioned NERA Economic Consulting to quantify the impact of tort litigation on small businesses. The results demonstrate that small businesses bear a significant share of tort liability costs:

- **The tort liability price tag for small businesses in America is $88 billion a year.** Small businesses, for purposes of this study, are defined as those with less than $10 million in annual revenue and at least one employee in addition to the owner.

- **Small businesses bear 68 percent of business tort liability costs, but take in only 25 percent of business revenue.** For a business with $10 million in annual revenue, the average tort liability cost is $150,000 per year.

- **For very small businesses, the tort liability price tag is $33 billion.** For purposes of this study, very small businesses are defined as those with annual revenue under $1 million and at least one employee in addition to the owner.

- **Very small businesses bear 26 percent of business tort liability costs, but take in only 8 percent of business revenue.** For a business with $1 million in revenue, the average tort liability cost is $17,000 per year.

- **Very small businesses pay 44 percent of their tort liability costs, or $15 billion, out of pocket, as opposed to through insurance.** This figure covers those costs that very small businesses must pay because they are uninsured, as well as costs they must pay above and beyond what insurance covers: deductibles, dollars above policy limits, exclusions in the policy, and punitive damages in states where they cannot be insured.

Politicians routinely pay homage to small businesses as the backbone of the American economy, yet little has been done to ease the burden placed on these enterprises by the steadily growing costs of litigation. This report demonstrates that litigation costs affect *every* business in America, from the largest of the Fortune 500 down to the neighborhood pharmacy.

Table 1

Small Businesses Bear Significant Tort Liability Costs

Revenue Categories	1992 Economic Census[1] Number of Businesses	Sales or Receipts	Percent of Total Sales	Estimated 2001 Revenues[1]	Estimated 2002 Business Liability Costs Insured Costs[2]	Self Insured or Uninsured[3]	Total	Percent of Total Costs	Liability Cost per $1,000 Revenues
	(1)	(2)	(3)	(4)	(5)	(6)	(7) (5) + (6)	(8)	(9) (7) / (4) x 1,000
		(billions)		(billions)	(billions)	(billions)	(billions)		
Less than $1 Million	3,807,253	$974	8%	$2,003	$18.4	$14.8	**$33.2**	26%	$16.58
$1 to $4.9 Million	609,988	$1,267	11%	$2,605	$40.6	$2.0	**$42.6**	33%	$16.35
$5 to $9.9 Million	94,547	$655	6%	$1,347	$10.7	$1.5	**$12.2**	9%	$9.03
Less than $10 Million	**4,511,788**	**$2,896**	**25%**	**$5,955**	**$69.7**	**$18.3**	**$88**	**68%**	**$15.00**
$10 to $24.9 Million	60,999	$932	8%	$1,916	$7.6	$2.3	**$10.0**	8%	$5.21
$25 to $49.9 Million	19,982	$688	6%	$1,415	$3.7	$2.6	**$6.3**	5%	$4.47
Greater than $50 Million	18,060	$7,096	61%	$14,590	$6.3	$18.2	**$24.5**	19%	$1.68
Total for all businesses	**4,610,829**	**$11,612**	**100%**	**$23,876**	**$87.4**	**$41.3**	**$128.8**	**100%**	**$5.39**

Sources:

Marsh Advantage America Account Data; Marsh Global Placement Data (BASYS); MarketStance data; A.M. Best "Best's Aggregates & Averages," 2002; 1992 Economic Census: Enterprise Statistics; Tillinghast-Towers Perrin, "U.S. Tort Costs: 2003 Update."

[1] Enterprises with at least one employee in addition to the owner. 2001 Economic Census data not yet released by revenue category. 2001 sales or receipts estimated as a multiple of payroll, which has been reported. Multiple is from 1997 census data and assumed to remain unchanged.

[2] Insured costs by revenue category estimated by NERA using Marsh data on insurance purchases by particular businesses. Aggregate values scaled to match aggregate premiums reported by A.M. Best for 2002 (adjusted to exclude Canadian exposure.)

[3] Uninsured costs estimated as multiple of insured liability costs. Insured liability costs estimated by multiplying premiums by combined ratio reported by A.M. Best for 2002. Distribution of premiums by revenue category estimated by NERA using Marsh data on insurance purchases by businesses of different sizes. Premiums scaled to match aggregate values reported by A. M. Best for 2002. Percentage of costs uninsured obtained from MarketStance. Values are scaled to match aggregate uninsured cost estimate reported by Tillinghast.

Table 2

Very Small Businesses Also Bear Significant Liability Costs

Revenue Categories	1992 Economic Census[1]: Number of Businesses (1)	1992 Economic Census[1]: Sales or Receipts (2) (billions)	1992 Economic Census[1]: Percent of Total Sales (3)	Estimated 2001 Revenues[1] (4) (billions)	Estimated 2002 Business Liability Costs: Insured Costs[2] (5) (billions)	Estimated 2002 Business Liability Costs: Self Insured or Uninsured[3] (6) (billions)	Estimated 2002 Business Liability Costs: Total (7) (5) + (6) (billions)	Estimated 2002 Business Liability Costs: Percent of Total Costs (8)	Liability Cost per $1,000 Revenues (9) (7) / (4) x 1,000
Less than $100 thousand	1,173,487	$63	1%	$129	$.6	$2.9	**$3.5**	3%	$27.20
$100 to $249 thousand	1,191,123	$197	2%	$406	$3.7	$10.5	**$14.2**	11%	$34.99
$250 to $499 thousand	851,460	$301	3%	$619	$5.8	$1.4	**$7.2**	6%	$11.66
$500 to $999 thousand	591,183	$413	4%	$850	$8.3	$.0	**$8.3**	6%	$9.75
Less than $1 million	**3,807,253**	**$974**	**8%**	**$2,003**	**$18.4**	**$14.8**	**$33.2**	**26%**	**$16.58**
Greater than $1 Million	803,576	$10,638	92%	$21,873	$69.0	$26.5	**$95.6**	74%	$4.37
Total for all businesses	**4,610,829**	**$11,612**	**100%**	**$23,876**	**$87.4**	**$41.3**	**$128.8**	**100%**	**$5.39**

Sources:

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Introduction

As long as Americans take pride in occupying the "Land of Opportunity," the small business will be venerated in this country. The creation and expansion of a small business embodies bedrock American values: initiative, inventiveness, hard work, and independence. The health of the small business sector is a national priority – from Congress, to state legislatures, to local communities.

Numerous studies have focused on the regulatory burdens that inhibit the growth and preservation of small businesses. This report quantifies, for the first time, the tort liability costs that fall on small businesses.

Tort liability as a public policy issue has been seen as primarily a corporate concern. The popular and legal media have focused their attention on blockbuster punitive damage awards, class actions against large corporations, and mass torts – suits that result from the mass production and distribution of products and services that are allegedly harmful to the public. The legal reform debate has been framed around the "deep pocket" phenomenon – the notion that our penchant for opportunistic litigiousness is expressed mostly when a wealthy target is available. Yet we know that suits are filed against small businesses all the time. To quantify the problem, the Institute for Legal Reform of the U.S. Chamber of Commerce commissioned NERA Economic Consulting to study the costs that the U.S. liability system imposes on small businesses.

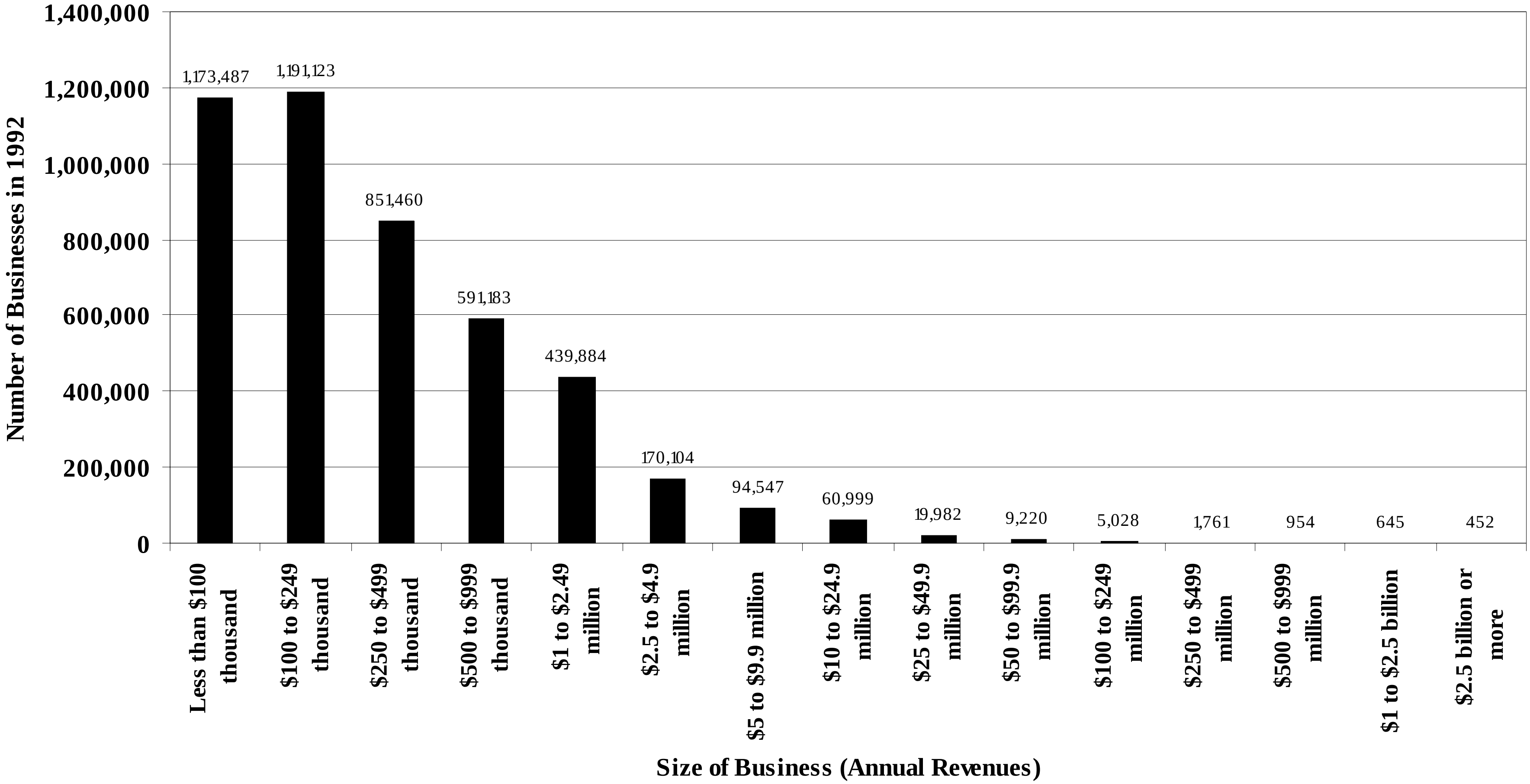
This report discusses the role that small businesses play in the U.S. economy, and presents the NERA findings on the costs of lawsuits brought against small businesses.

Small Businesses And The U.S. Economy

Small businesses (defined for this study as enterprises with annual revenue under $10 million and at least one employee in addition to the owner) account for 98% of the total number of businesses with employees in the United States. Table 4 shows the number of U.S. businesses in each revenue category.

Table 3

Most U.S. businesses are small



Source: 1992 Economic Census: Enterprise Statistics

Professor George Priest of Yale Law School, in an article about the importance of small businesses to the U.S. economy, quotes a White House report on The State of Small Business:

> *Small businesses represent the individual economic efforts of our Nation's citizens. They are the foundation of the Nation's economic growth: virtually all of the new jobs, 53 percent of employment, 51 percent of private sector output, and a disproportionate share of innovations come from small firms. Small businesses are avenues of opportunity for women and minorities, first employers and trainers of the young, important employers of elderly workers, and those formerly on public assistance. The freedom of America's small businesses to experiment, create, and expand makes them powerhouses in our economic system.*[*]

Small businesses contribute significantly to the economic growth of the nation, they provide economic opportunities generally and to specific groups such as the elderly and minorities, and working in a small business offers non-economic benefits such as independence and self-reliance.

In recognition of the contributions small businesses make to the economy and to American values, Congress often enacts programs to protect and encourage small business development: the financing of small business initiatives, special forms of tax treatment and debt relief, to name just a few. Many federal laws provide set-asides or other differential premiums that provide opportunities for small businesses. However, there has not been sufficient recognition of the burden that litigation places on small businesses.

Liability Costs

There has been a paucity of data detailing the costs of the U.S. tort liability system.[†] The courts do not publish any cost data, nor do they publish data from which a cost estimate could be developed. In 1985, Tillinghast-Towers Perrin stepped in to fill the void and published the first of what have been several updates of an aggregate cost estimate of

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[*] Quoted in Priest, George L, 2003, Small Business, Economic Growth, and the Huffman Conjecture, *Journal of Small & Emerging Business Law* 1.

[†] Tort suits against businesses are most often based on allegations of: workplace accidents that affect non-employees; transportation accidents; product failures or defects; negligent management of publicly held companies by directors and officers; negligent business practices; or negligent employment practices.

the tort liability system.[‡] Policymakers, scholars, and the legal profession have come to rely on the Tillinghast studies. The most recent Tillinghast study estimates the total costs of the tort liability system to be $233 billion. This does not include the costs of the court system.[§]

Moreover, the Tillinghast study did not estimate the indirect costs of the tort liability system, which are difficult to measure accurately. Indirect costs include reduced innovation, and the loss of safe, useful services or products that were discontinued because they might be magnets for unjustified litigation.

Of the $233 billion overall tort liability costs, Tillinghast estimated that $129 billion falls on businesses. Of the remaining costs, $80 billion is for personal liability (and is handled largely through car insurance and homeowners' insurance), and $25 billion is for medical malpractice.

The U.S. Chamber Institute for Legal Reform sought to understand how these costs affect different segments of the business community, and asked NERA to calculate the costs borne by businesses of various sizes. NERA's breakdown is based on published insurance data and on proprietary data from Marsh, Inc., one of the largest broker/agents in the insurance industry.[**] (See Technical Appendix for the methodology.)

NERA's findings are as follows:

- **The tort liability price tag for small businesses in America is $88 billion a year.** Small businesses, for purposes of this study, are defined as those with less than $10 million in annual revenue and at least one employee in addition to the owner.

- **Small businesses bear 68 percent of business tort liability costs, but take in only 25 percent of business revenue.** For a business with $10 million in annual revenue, the average tort liability cost is $150,000 per year.

[‡] Tillinghast-Towers Perrin, *U.S. Tort Costs: 2003 Update.* The Institute for Civil Justice at RAND published a thorough cost study of the tort system in 1986, *Costs and Compensation Paid in Tort Litigation*, which is now outdated.
[§] Costs of the workers compensation system are not included in the Tillinghast study or this study.
[**] NERA is a subsidiary of Marsh, and thus uniquely positioned to get access to Marsh data.

- **For very small businesses, the tort liability price tag is $33 billion.** For purposes of this study, very small businesses are defined as those with annual revenue under $1 million and at least one employee in addition to the owner.

- **Very small businesses bear 26 percent of business tort liability costs, but take in only 8 percent of business revenue.** For a business with $1 million in revenue, the average tort liability cost is $17,000 per year.

- **Very small businesses pay 44 percent of their tort liability costs, or $15 billion, out of pocket, as opposed to through insurance.** This figure covers those costs that very small businesses must pay because they are uninsured, as well as costs they must pay above and beyond what insurance covers: deductibles, dollars above policy limits, exclusions in the policy, and punitive damages in states where they cannot be insured.

Small business tort liability costs consist of:

- Settlements, awards, and defense costs paid directly by uninsured businesses
- Liability insurance premiums, and costs incurred by insurance companies on behalf of policyholders
- Liability insurance deductibles
- Damages excluded from insurance policies
- Damages exceeding policy limits
- Punitive damages, in states where they cannot be insured

Most small businesses buy liability insurance to protect themselves from lawsuits. But the decision to buy liability insurance is not as simple as it might seem. Without liability insurance, a small company can be devastated by one lawsuit. On the other hand, money spent on liability insurance could have been spent instead in ways that might contribute to the growth of the business. And having insurance may make a business the target of opportunistic parties who realize that insurance means there are resources to be tapped.

There is no "management science" that resolves this issue for the small business owner. To quote a small business owner who testified before the U.S. House of Representatives: "The owner is put in a precarious position. If he carries less insurance coverage, he exposes his business every day to risks that are otherwise foreseeable, and therefore, manageable. On the other hand, if he is responsible and carries adequate coverage, he may be a greater litigation target because his participation in the suit could lead to a large indemnity payout. Business owners like him operate as responsible professionals, but commercial liability is a considerable expense, as are the labor hours missed and attorney fees necessary to protect his shop."[††]

The following table illustrates patterns of purchasing insurance among small businesses of different sizes:

[††] Richard E. Dinger testifying on behalf of the Independent Insurance Agents of America before the House Committee on the Judiciary, House of Representatives, 106th Congress, 1st Session, September 29, 1999

Table 4

Some Small Businesses Do Not Buy Insurance

	Number of Employees		
	1 - 9	**10 -19**	**20 - 249**
Buy Insurance	65%	83%	77%
Buy Insurance <u>and</u> Self-Insure	17%	14%	20%
Self-Insure	16%	2%	3%
Those Who Buy Insurance Purchase the Following:			
Product or Professional Liability Including Negligence, and Errors and Omissions	67%	67%	72%
Environmental Liability	17%	20%	25%
Slips and Falls, and Similar Liability Claims (Premises Liability)	72%	79%	82%
Vehicle Collision and Liability	69%	70%	82%
Employment-Related Liability such as Defamation or Wrongful Termination	17%	30%	38%

Source
"NFIB National Small Business Poll, Business Insurance," *NFIB Research Foundation*, 2002.
May not total 100% due to rounding.

Conclusion

Small businesses bear a significant share of the costs of the U.S. tort liability system. These same businesses generate 60 to 80 percent of the net new jobs each year, and pay approximately 40 percent of the total private payroll in the United States, according to the Small Business Administration. Therefore, excessive tort liability costs have a direct impact on employment and prosperity in America.

Politicians routinely pay homage to small businesses as the backbone of the American economy, yet little has been done to ease the burden placed on these enterprises by the steadily growing costs of litigation. This report demonstrates that legal reform is not just a corporate issue; litigation costs affect *every* business in America, from the biggest of the Fortune 500 down to the neighborhood pharmacy.

The findings of this study show the need for meaningful common-sense legal reforms at the federal and state levels. In order to sustain a strong economy, and to restore a fair and rational legal system, policymakers should rein in runaway non-economic damages, address the issue of joint and several liability, curb forum-shopping, and consider other comprehensive reforms of the legal system.

These steps will strengthen small business, and strengthen America.

Technical Appendix

Explanation of the Analysis Performed for this Study

Business liability costs are estimated using data on actual insurance purchases for customers of Marsh, Inc. (one of the world's largest commercial insurance brokers), combined with estimates from MarketStance (a market research firm specializing in insurance) of costs that are not covered by insurance. U.S. census data are used to scale up the average costs for the sample of businesses to estimate the costs for the U.S. economy as a whole. For the purpose of this study businesses are defined as enterprises with payroll.

Estimating Liability Costs

Average insurance costs per $1,000 in business revenue for businesses of different sizes are multiplied by the aggregate revenue of all businesses of the same size in the U.S. economy and the estimated proportion of businesses buying liability, umbrella/excess and commercial automobile lines of insurance. These aggregate values are scaled by a calibration factor so that the total premium cost equals the value reported by A.M. Best for premiums earned by insurance companies in 2002 (adjusted to remove premiums paid by Canadian businesses).

The actual costs of insurance to businesses of different sizes were analyzed using three samples of Marsh insurance customers. These samples of data correspond to separate Marsh brokerage operations that focus on small businesses and larger businesses.

The proportion of all businesses that buy liability insurance (either general liability or specialized liability lines) is assumed to equal the proportion of liability costs that are insured (estimated by MarketStance.) The proportion of businesses that buy umbrella or automobile lines is estimated as a fraction of the proportion buying liability lines. The appropriate fractions are estimated using Marsh account data by comparing the number of businesses in each size category that buy umbrella or automobile lines to the number that buy liability lines (either general liability or specialized liability lines).

The total liability costs that businesses pay consist of insurance premium costs and costs associated with uninsured and self-insured out-of-pocket costs. The proportion of liability costs that are uninsured or self-insured by businesses themselves is estimated by MarketStance. MarketStance data are reported by size of business, measured in terms of the number of employees. We used average revenue of businesses in each size category to estimate the uninsured costs for businesses in each revenue category.

Uninsured costs to businesses are estimated by multiplying the estimated insured costs by the uninsured proportion of liability costs estimated by Market Stance. Insured costs are calculated by adjusting premiums earned by the combined ratio for the corresponding lines reported by A.M. Best for 2002. Insurers use this ratio to express the cost of paying losses, administering policies and underwriting insurance as a percent of the premium revenue they earn. Aggregate uninsured costs are scaled by a calibration factor to match the aggregate uninsured costs reported by Tillinghast.

Lines of Insurance Analyzed in This Study

Insurance lines used in this analysis consist of commercial liability lines (the components of which are described below), umbrella or excess liability, commercial automobile lines and liability components of packaged products including commercial multi-peril and business owner policies. The fraction of multi-peril costs associated with the liability component of coverage was assumed to equal the fraction of aggregate multi-peril premiums designated as liability premiums by A.M. Best. The liability component of small business packaged policies (including Business Owners' Policies) was estimated based on the average share of total insurance costs represented by liability lines for small businesses that buy single line policies.

Commercial liability lines include many specialized lines. For this study, we used the largest lines, which together account for 90 percent of total commercial liability premiums. These lines consist of:

- General Liability
- Miscellaneous Casualty
- Multi-Peril Casualty (liability component only)
- Pollution Legal Liability
- Directors & Officers Liability
- Professional Services Firm Indemnity
- Errors & Omissions
- Employment Practices Liability
- Fiduciary Liability

Combining Insurance Data from Different Samples

Small business data were obtained from the Marsh Advantage America group. These data consist of a sample of mostly packaged policies placed through Marsh's San Antonio group and a sample of mostly single-line policies placed through Marsh's Tampa group. The data for larger businesses consist of global placement clients of Marsh's Casualty practice and its Finpro practice, which places Directors & Officers Liability, Professional Services Firm Indemnity, Error & Omissions and other professional liability lines. These data reside in Marsh's BASYS database. See below for a description of how these samples were combined.

Data from the San Antonio sample, the Tampa sample, and the global placement database are combined to create weighted average estimates of insurance costs for each size category. The Tampa data do not include professional liability lines. The average liability costs in this sample are increased to account for these lines, based on purchases of businesses of similar size in the global placement data.

The San Antonio accounts consist principally of businesses with 10 to 25 employees. Typical businesses in this group are estimated to have less than $500,000 in revenue, although some have revenue as high as $2.5 million. These businesses mainly buy packaged policies. Most of the smallest firms buy Business Owners Policies, which typically combine property, general liability and automobile coverage. The San Antonio data includes aggregate statistics for all 9,000 accounts and a sample of 1,700 accounts that have average premiums of $3,000 and typical deductibles of $500, $5,000, or $10,000.

The Tampa accounts consist principally of businesses with revenue between $500,000 and $50 million. Premiums for the smallest businesses in this group – those with less than $500,000 in revenue – are comparable to the average single-line premiums in the San Antonio sample. The sample consists of over 3,000 open accounts, with average premiums of $60,000 (median $36,000).

Global placement accounts consist principally of businesses with more than $1 million in revenue. There are more than 11,000 businesses in this group, and their average liability premium is $400,000.

For businesses with revenue under $100,000, values are calculated using packaged account data from Marsh Advantage America's San Antonio group.

For businesses with revenue between $100,000 and $500,000, values are calculated as the weighted average of non-packaged account data from the San Antonio sample and the corresponding size accounts from the Tampa data. For businesses with revenue between $500,000 and $1 million, values are calculated using the Tampa data. For business with revenue between $1 million and $250 million, values are calculated as the weighted average of the Tampa data and global placement data. For businesses with revenue greater that $250 million, values are calculated using the global placement data.

Aggregate U.S. Insurance Premiums

A.M. Best publishes Best's Aggregates & Averages Property/Casualty United States & Canada each year, in which aggregate premiums are calculated from insurance companies' regulatory filings. Lines of insurance (as classified by A.M. Best) that are relevant to this study are 1) the liability portion of commercial multiple peril lines, 2) product liability lines, 3) other liability lines, and 4) other commercial automobile liability lines excluding no-fault lines.

The "other liability lines" category includes general liability, and also includes the other specialized lines analyzed using the Marsh data: pollution liability; directors & officers liability; professional services firm indemnity; errors & omissions; employment practices liability; fiduciary liability.

Estimating Business Revenue in the U.S. Economy

We use data from the U.S. Economic Census for 1992, 1997 and 2001. The number of businesses of different size measured in terms of their sales and receipts (i.e., revenue) is reported for 1992. These data are not yet published for 1997 or 2001. However, payroll statistics are available for these years. We use the ratio of revenue to payroll to estimate aggregate revenue for businesses in 2001. We use 1992 data to analyze the costs of insurance to businesses with different levels of revenue. We then scale these results up to account for the increase in aggregate revenue between 1992 and 2001.

Limitations of the Data

- Marsh data on cost of insurance may be biased towards businesses with higher insurance costs, since these businesses may be more likely to use a broker.

- Marsh data may under-represent package business since most of this business is underwritten directly by regional insurers.
- Uninsured/self-insured cost percentages were estimated by MarketStance for businesses by employee size categories – these had to be mapped approximately to revenue categories.
- First-party property losses are not a component of liability costs and are excluded from the analysis; non-property related first-party losses that are covered by liability policies cannot be excluded using the available data, but are minimal.

Assumptions in the Study

The data sources used for this analysis imposed limitations. We made the following assumptions:

- The distribution of sales and receipts by enterprise for 1992 is representative of the current distribution.
- Non-employee businesses bear a negligible fraction of liability costs.
- Marsh account data consist of a representative mix of accounts of different sizes.
- The fraction of businesses that buy liability insurance (either general liability or specialized liability lines) is proportional to the liability costs that are insured, as estimated by MarketStance.
- The proportion of Marsh customers buying specific lines and the associated costs for businesses within each size category (after calibration) are representative of typical insurance purchases.
- MarketStance estimates of uninsured/self-insured costs for businesses of different employee size categories accurately represent the uninsured/self-insured costs of businesses with corresponding average revenue.

Glossary of Terms

- Primary insurance policy: the first insurance policy against which claims are made for a specific line of coverage
- Umbrella/excess insurance policy: secondary insurance coverage against which claims are made after primary policies have paid out
- Limits: the insured amount of a policy
- Self-insurance: either uninsured, high deductibles, or insured through alternative risk transfer such as captives
- Retentions: also known as self-insured retentions or deductibles
- Uninsured: exposure for which no insurance coverage is purchased
- Business owners policy (BOP): packaged policy that combines property, general liability, and hired and un-owned automobile coverage
- Packaged policy: standardized insurance that combines several lines of coverage in a single policy with a simplified policy form

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About the Institute for Legal Reform

Founded in 1998, the U.S. Chamber Institute for Legal Reform (ILR) is a 501 (c) (6) tax-exempt, separately incorporated affiliate of the Chamber. The mission of ILR is simple: to make America's legal system simpler, fairer and faster for everyone. ILR's multifaceted program seeks to promote civil justice reform through legislative, political, judicial and educational activities at the national, state and local levels.