

LIABILITY LESSON

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To be able to survive and sustain, organizations need to ensure continuity of their operations and preservation of their assets. They are exposed to various risks and therefore in order to sustain themselves to achieve corporate goal the organization must have a Risk Management Policy. As a result of social changes, rapid technological advancements and the prevailing political, economic and legal environment, the organizations are faced with a new threat to their existence – the one emanating from legal liability under tort, statutory law and contract. The liability exposure alongwith other areas of loss exposure therefore should form Part of the overall risk management policy of any organization.

Before we discuss insurance part of it, let's examine risk management per se from the point of view of an organization which typically consists of

- i) Risk Analysis
- ii) Risk Control
- iii) Risk Financing
- iv) Monitoring and review

Risk Analysis basically involves identification and evaluation of risk. We first identify the areas of risk exposure e.g. assets, earning capacity, human resource, legal liabilities, etc. and then correlate them with possible sources of loss/ damage/ injury. What is the probability of happening of such a loss and its likely severity is then evaluated. Broadly speaking there may be "high frequency and low severity" and "Low Frequency and high severity" losses. The next step in the process is Risk Control measures which is aimed at avoiding, eliminating or reducing the chances of loss producing events. This also involves measures for diminishing the severity of loss that has occurred.

These can be achieved by technical improvement, procedural changes, TQM approach and loss prevention measures. Since these involve substantial amount of money, a cost-benefit analysis is carried out before the actual measures are initiated, though any progressive management would regard all loss prevention activities as not to be dispersed with. In spite of the best efforts in preventing accidents / losses, they do take place and the organizations must have to find ways to finance them. The possible options are insurance / ART, finance by loan, creation of contingency fund, losses to be charged to operating costs, etc. We are living in a dynamic world and any policy / strategy needs to be continuously reviewed and monitored to effect change if so warranted.

Let's now examine the legal liability and its implication on an organization. Let's also examine the evolution of liability legislation and the prevailing judicial attitude. This is necessary because the liability insurance has to necessarily move along the path determined by both the liability legislation and the court decision / judgment. Legal liability may be defined as specific responsibilities and obligations which can be enforced at law. We are here basically concerned with civil liability which may arise under (i) Law of Tort (ii) Statutory Law (iii) Law of Contract. It should be noted that for any civil wrong suits can be filed for damages / injury. It should also be noted that there is no escape from liability under statutory and contract law provision.

Originally everybody abided by the principle - "you pay for your own losses." However with the passage of time the notion of fault got incorporated in civil law, which meant that if you are responsible for the damages / injures you have to pay the monetary compensation. But this required the establishment of "fault" in the court law - a difficult task indeed. Therefore, in order to help the victims and to safeguard his interest, the onus of proof was shifted to the defendant who has to prove his innocence rather than the victim proving the negligence on the part of tort-feasor. The principle that "for every **wrong** there must be redress in the form of damage" has now changed to "for every **injury**

there must be redress in the form of damage.” With this change has come the concept of “strict or absolute liability” which means that mere existence / operation of an activity constitute the cause triggering liability - the only requirement being a causal link between the activity and the loss event. With growing awareness about the environment, preservation of flora & fauna, the assets belonging to society as a whole (eco-system) are being brought in the liability net, the guiding principle being “the polluter pays.” Retroactive application of these laws has their own implication.

In order to ensure that the victims get the compensation (where the liable party is not in a position to pay) the concept of “group common fate has been introduced. Several parties are held jointly responsible in accordance with their ability to pay creating “deep pocket” approach. This means that persons / parties who have nothing to do with the original event may be fastened with liability. The net of liable parties is thus widening. Of late there has been trend to award punitive damage as a deterrent to the perpetrators, apart from soaring compensation payments. Sometimes the punitive damages exceed the actual damage awarded.

In the light of the above, it should now become very clear that other than Act of God peril, there is hardly any legally permitted exoneration pleas and hence the extent of liability exposure can very well be imagined / understood. It will not be out of place here to mention a few relevant court cases, which are indicative of the shape of things to come in future. In the case of SriRam Foods & Fertilizer where oleum gas escaped from one of the units resulting in injuries to many, the Supreme Court held that the liability to compensate is absolute and that Chairman / MD/ Officers heading the plant are personally liable to pay the compensation. In Uphaar Cinema tragedy the court has held MCD, Delhi Police and DESU (All public agencies) jointly responsible for the payment of compensation. A leading software Indian Co. has to settle for an out of court settlement in a sexual harassment case against one of its

employees in USA. The liability exposure arising out of cases like Bhopal Gas Tragedy can be well imagined. At this stage it will not be out of place to have a look at statutory laws governing civil liability. Apart from tort they are –

- WC Act 1923 (as amended)
- Factories Act 1948
- Consumer Protection Act 1986
- The Environment Protection Act 1986
- National Environment Tribunal Act 1995
- Public Liability Insurance Act 1991
- Law of Contract

Those falling within the purview of WC Act 1923 & PLI Act, 1991, have to necessarily take Insurance cover as provided in the Act. As for the liability under other statutes and the liability under tort the companies have to plan for them in their Risk Management Programme.

Let's now examine the position from the point of view of Insurers. Let's first start with the pricing part of it. It is an accepted principle of insurance pricing that there should be proper matching between the rate of premium and degree of exposure in terms of probability of loss. Liability claims being long-tail, open-ended, and intangible, pose problem in working out the premium rate. It is difficult to objectively measure the probability because of lack of adequate data- base and also because the liability fixed is very subjective based upon the prevailing judicial attitude. The Risk / premium balance is disturbed because the liability standard as prevailing in a future date will decide the outcome of the events that has already taken place in the past and which incidentally was underwritten in the past based on the then prevailing condition. Besides it is very difficult to quantify objectively the loss on account of pain / suffering / mental agony, damage to eco-system, environment, etc.

Keeping the above factors in view and the requirements of the market, Indian Insurance Company have many liability products to offer. However, in order to keep their financial commitments within their limit of retention, the insurance companies sets out two limits called AOA (Any one accident limit) and AoY (Any one year limit) in all liability insurance policies. In liability claims, at times, the insured event do not occur suddenly and accidentally but manifests itself only gradually and hence it becomes difficult to ascertain whether cover exists from a time -related point of view. These are called gradual loss event. Therefore the following three concepts typical to liability insurance need to be understood:

- Retroactive date - It is the date when the first policy issued commences and will continue to be the retroactive date for subsequent policies if renewed without break.
- Policy period. It is the one year policy period as depicted on the face of the policy.
- Period of insurance - It means the period commencing from the retroactive date and continues, if the policies are renewed without break, till the expiry date in the last policy.

In relation to the claims, to find out whether insurance coverage in a particular case applies or not, there are three types of policy wordings.

- 1) Occurrence basis: The damage / injury must occur during policy period. Claim may occur after expiry also.
- 2) Claims made basis: the claim is made during the policy period irrespective of when the negligence occurred.
- 3) Acts committed basis: The negligent act must occur during the policy period.

The courts, however, have interpreted the wordings in their own way and there are conflicting judgments specially in USA.

In India, the indemnity clause generally provide the cover for

- Claims arising out of accidents, during the period of insurance
- First made during the policy period.

This means that the event must occur during the period of insurance and the policy is continuously in force without break till the time the claims is reported.

The following liability insurance products are available in Indian market.

- Public liability for industrial and non-industrial risk.
- Product liability
- Professional indemnity for Doctors / Solicitors, etc.
- Employer's liability
- Directors' and Officers liability
- Act policy under PLI Act (hazardous goods) 1991.
- Motor, marine hull and aviation policies also cover T.P. liability.
- CAR, EAR, IAR, etc have provision to extend cover to T.P. liability.

Depending upon the specific needs of a client, tailor made policy can also be made. Some of the private insurance companies have come out with products like commercial general liability insurance cover.

It should be noted that liability insurance by its very nature has the potential to result is heavy losses of catastrophic nature. Hence the reinsurance support is required. However, in view of limited insurance capacity, higher premium, increased deductibles a need is felt about alternative risk transfer mechanism (ART). This is being attempted by transfer of risk through capital market instruments e.g. CAT Bonds. Therefore, optimized risk transfer at optimal price may involve combination of insurance & ART. In this regard a new concept is gaining currency in European market to avoid complications from liability laws and unpredictable nature of court judgments. The concept of "First party" cover takes the place of liability insurance specially for covering environmental liability. Instead of the tort-fearer taking the policy, the would

be aggrieved party takes the “First party” covers. In the event of any damage, instead of locating the tort fearer, the aggrieved party without going through the court mechanism claims compensation from the insurance company.

The ever-increasing entitlement - mentality of society, the widening net of liability legislation, and the trend of court judgments may well have a very negative effect on the economy and more so on small entrepreneurship. We have to think of innovative ways to come out with solutions, which takes care of the need of not only big organizations but also SSI's and SME's who are the most vulnerable. The solutions must be cost effective and innovative in nature.