A

CBO

STUDY

The Economics of U.S. Tort Liability: A Primer

October 2003

The Congress of the United States ■ Congressional Budget Office

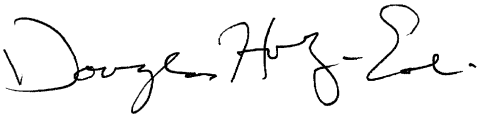
PREFACE

Many controversies and policy issues surround the U.S. tort system, which holds parties liable for injuries to people or property. Critics charge that the system is costly and inefficient, arbitrary and open to abuse, and indirectly harmful through its adverse effects on economic vitality and consumers' choices. In contrast, defenders argue that the tort system serves important social objectives, such as compensating injury victims, improving product safety, and punishing egregious behavior. Several bills now before the Congress propose to change the rules that govern tort claims for medical malpractice and asbestos exposure and claims litigated as class actions.

This Congressional Budget Office (CBO) study—prepared at the request of the Senate Budget Committee—attempts to clarify the issues and policy options surrounding the tort system by presenting an economic perspective on tort liability. The study outlines the strengths and weaknesses of tort liability as a tool for promoting economic efficiency and fairness, discusses the available data on the benefits and costs of the tort system, and analyzes in qualitative terms the likely effects of various policy options for altering the system. In keeping with CBO's mandate to provide objective, impartial analysis, this study makes no recommendations.

Perry Beider and Cary Elliott of CBO's Microeconomic and Financial Studies Division wrote the study, under the supervision of David Moore and Roger Hitchner. The authors received valuable comments and assistance from Heywood Fleisig, Stuart Hagen, and Robert Murphy of CBO, as well as from Jeff O'Hara, formerly of CBO; Christopher DeMuth of the American Enterprise Institute; Paul Rubin of Emory University; Alan Sykes of the University of Chicago; and Paula Hannaford-Agor and Neil LaFountain of the National Center for State Courts.

Christian Spoor edited the study, and Christine Bogusz proofread it. Maureen Costantino took the cover photograph and designed the cover. Lenny Skutnik printed the initial copies of the report, and Annette Kalicki prepared the electronic versions for CBO's Web site (www.cbo.gov).



Douglas Holtz-Eakin
Director

October 2003

CONTENTS

Tables

Summary

A "tort" is an injury to someone's person, reputation, or feelings or damage to real or personal property.[1] Under the U.S. system of tort liability, courts can hold injurers liable for many different types of torts, such as automobile accidents, contract fraud, trespass, medical malpractice, and injuries associated with defective products.

Several bills now before the Congress seek to address concerns that critics have raised about the tort system or about certain types of tort cases. Among those concerns are that:

- The "transaction costs" of the system, particularly attorneys' fees, are too high;
- Punitive damages and compensatory damages for pain and suffering are often awarded arbitrarily, with no beneficial effect on safety;
- The class-action mechanism (whereby many claims that cover similar factual ground are combined into a single larger case) is easily abused by plaintiffs' attorneys;
- Medical malpractice lawsuits are driving up the costs of liability insurance for physicians to the point that some of them are restricting their practices or retiring; and
- In suits over exposure to asbestos, too much money and court time are being devoted to people who do not yet show any signs of physical impairment.

Conversely, supporters of the existing tort system argue that it serves important policy goals, such as compensating victims, holding injurers responsible for their actions, and improving safety. Supporters say that critics overstate the extent and severity of the perceived problems with the system. They further argue that many of the proposed changes are too broad and that major problems can be addressed by the courts or through more narrowly targeted legislation, perhaps at the state level, where the vast majority of tort lawsuits are filed.

This primer looks at the current tort system—and various options for changing it—from an economic perspective, focusing on the goals of efficiency (minimizing the system's total cost to the economy) and equity (treating all parties fairly). Data about the overall costs and benefits of tort liability are too scarce to allow economists to judge the efficiency of the current system. However, those data suggest that the system is a relatively expensive way to compensate victims and, thus, that any justifications for it must be based on its effects on deterring injuries, promoting equity, or both.

1. Bryan A. Garner, ed., *Black's Law Dictionary*, 7th ed. (St. Paul, Minn.: West Group, 1999), pp. 1496-1497.

The economic perspective leads to some other general conclusions about tort liability:

- Using the tort system to supplement market forces may improve or reduce efficiency, depending on what incentives the system creates for potential injurers and potential victims and on the interactions between those incentives, government regulations, and private insurance policies;

- Altering the tort system generally involves some trade-offs—in particular, changes that seem likely to improve efficiency may be problematic in terms of equity, or vice versa;

- Federal involvement in what is now mainly a matter of state law might yield more-efficient interstate commerce, but it could limit innovation at the state level (as well as restrict the states' ability to offer contrasting liability regimes to appeal to different residents); and

- The same policies may not be appropriate for all types of tort cases, because efficiency requires minimizing the sum of several kinds of costs, which may vary in their relative importance from one category of tort to another.

Tort Liability in the United States

The U.S. tort system is not centralized, which makes collecting comprehensive data about it difficult. Roughly 95 percent of lawsuits over torts are filed in state courts, rather than federal courts, the Congressional Budget Office (CBO) estimates. Moreover, in the vast majority of cases, plaintiffs and defendants reach out-of-court settlements, whose terms typically remain private. (For example, 97 percent of tort cases that "terminated" in federal district courts in fiscal year 2000 were disposed of before a verdict was reached.)

Data from the Bureau of Justice Statistics that cover 45 of the nation's 75 largest counties indicate that plaintiffs won 48 percent of the cases that reached a verdict in state courts in 1996 (the latest year for which that information is available).[2] In those cases, the average time between filing and completion was 22 months. Automobile-related torts accounted for 49 percent of the cases, followed by premises liability (22 percent) and medical malpractice (12 percent). The median award to successful plaintiffs was $31,000 for all cases, but it varied widely for different categories of torts: from $18,000 in automobile-related cases to $286,000 for medical malpractice and $309,000 in asbestos cases.

Looking at trends over time, data from 16 states tracked consistently by the National Center for State Courts show that the number of tort cases filed each year rose by 70 percent between 1975 and 1990 (its peak) and then fell by 19 percent by 2000. Relative to population, the rate of filings was 8 percent lower in 2000 than in 1975—212 cases per 100,000 residents compared with 230 cases.[3]

Figures that suggest an overall decline in tort cases, however, mask continuing growth in the number or impact of some important categories of torts. For example, the Physician Insurers Association of America reports that median court judgments for medical malpractice rose from $100,000 in 1990 to more than $300,000 in 2001—an increase of 138 percent after correcting for inflation. And researchers at RAND report that the number of claims filed for asbestos exposure nearly tripled in just two years, between 1999 and 2001.

The Basic Economics of Tort Liability

From the economic point of view, the efficiency of the tort system is measured by how well it minimizes the sum of several types of costs:

---

2. Department of Justice, Bureau of Justice Statistics, *Tort Trials and Verdicts in Large Counties, 1996*, NCJ 179769 (August 2000).

3. See Brian J. Ostrom, Neal B. Kauder, and Robert C. LaFountain, eds., *Examining the Work of State Courts, 2001: A National Perspective from the Court Statistics Project* (Williamsburg, Va.: National Center for State Courts, 2001), with accompanying spreadsheets available at www.ncsconline.org/D_Research/csp/2001_Files/2001_Tort-Contract_Tables.xls.

- The costs of injuries (including medical costs, lost productivity, and pain and suffering);

- The costs of efforts to prevent or avoid injuries (including efforts to make products safer, which tend to raise consumer prices) and the opportunity costs of goods and services that are not provided (such as potential medical drugs that do not reach the market or municipal pools that are closed for fear of lawsuits) or goods and services that are provided but forgone by some risk-averse consumers (such as air travel);

- The costs of administration and implementation (particularly attorneys' fees and the administrative costs of insurance that potential injurers and victims buy to redistribute the risks they face); and

- Indirect costs to the economy (such as the disruption costs of plant closings and bankruptcies).

What constitutes equity in relation to the tort system is ultimately subjective, but there is consensus that compensating victims for their injuries—at least in some cases and to some degree—is equitable.

Tort liability is only one means by which society addresses the efficiency and equity issues posed by injuries; other means include market forces, regulation, and public insurance funds. Market forces can help control injury costs in several ways. Under conditions of competition and good information, producers of goods and services respond to consumers' desires for safer products, employers respond to employees' desires for safer workplaces, and insurance companies offer policies to respond to potential victims' desires to reduce the uncertainty they face.

One efficiency rationale for supplementing market forces with some form of government involvement is simply that many injuries—automobile accidents, releases of toxic chemicals, and so forth—are unrelated to any economic transaction. Indeed, some academic economists favor restricting the scope of tort liability to such "stranger" injuries. For other types of injuries, making an efficiency argument for government intervention requires the existence of some market imperfection: perhaps potential victims lack good information about the risks they face, suffer from biases that limit their ability to use the information, or have few choices because of monopoly or collusion in the market.[4] Of course, government actions have their own weaknesses and thus may not improve efficiency in practice. For example, regulation requires centralized information about costs and benefits, and regulators may be co-opted by the parties they regulate.

Tort liability supplements the market in a more decentralized way. The basic idea is that making injurers pay for the harm they cause not only compensates victims but also gives injurers (if not victims) appropriate incentives to reduce the frequency and severity of that harm. The different liability standards used by the courts aim to achieve those goals in different ways: in particular, under the doctrine of strict liability, injurers are responsible regardless of how much care they exercise in trying to minimize injuries, whereas under the doctrine of negligence, they are responsible only if their actions fail to meet a standard of due care.[5]

The tort system is no panacea, however, even in principle—it is difficult if not impossible to craft liability rules that can consistently achieve the desired levels of both efficiency (taking into account all of the relevant costs) and equity. For example, because the expected level of compensation may affect the degree of care that potential victims exercise, the efficiency objective of cost-effective deterrence can conflict with the equity objective of compensation. Moreover, because the terms of that trade-off can vary, a single rule may not achieve the desired balance between efficiency and equity in all cases.

In practice, tort liability is further limited because information—particularly the information needed to determine the cause of an injury—is incomplete and costly. The transaction costs of the tort system derive from information problems: lack of complete information is

4. There is no presumption that market forces tend to produce equitable outcomes; hence, arguments for government intervention can also be made on equity grounds.

5. Even in a case judged under strict liability, the injurer may not be held responsible if the victim's own behavior contributed too much to the occurrence of the harm.

what allows plaintiffs and defendants to hold divergent views and encourages them to devote resources to proving their respective cases. Information problems are also the root cause of courtroom errors, and they can make it hard to set standards for due care at efficient levels.

The Costs and Benefits of Tort Liability

Analyzing the policy questions that surround tort liability is difficult because of incomplete data not only on tort cases themselves but also on the indirect costs and benefits of the tort system. Indeed, from the standpoint of economic efficiency, the actions that the system encourages potential injurers and victims to take (or refrain from taking) to avoid injuries can be more important than some of the direct "costs" associated with individual cases.

In efficiency terms, the primary benefits of the tort system are measured not by payments to victims—which represent transfers of wealth but not gains or losses to society as a whole—but by reductions in injury costs. Those benefits arise indirectly, through precautions taken by potential injurers (for example, efforts to design safer products or reduce production defects).[6] Thus, they are not observable in data on trials or settlements.

Several important types of costs are also indirect, including the costs of specific actions that firms take to reduce the injury risks associated with their products (such as including air bags in automobiles), the opportunity costs of goods and services not offered because of liability concerns or not purchased because of liability-related price increases, and the disruption costs of layoffs and bankruptcies.

Arguments About the Effectiveness of Tort Liability's Incentives

Indirect benefits and costs are very difficult to measure. In general, data do not exist to show how liability affects the degree of care that potential injurers take—let alone how injury costs change as a result of that care. Moreover, theoretical analysis alone cannot answer the key questions, because the extent to which the potential efficiency benefits of tort liability are realized depends on the relationship between the true costs of injuries and the expected costs to injurers. If potential injurers expect to pay one dollar more for each additional dollar of injuries they cause, they will have the optimal incentive to take all (and only) cost-effective precautionary actions. But they might anticipate paying more than one dollar per dollar of additional injury (for example, because of excessive punitive damages) or less than that (for example, if some of their torts go undetected or if their liability costs are insured and their premiums do not rise commensurately). For potential injurers whose actions are thought at the time to be harmless—such as the firms that manufactured or used asbestos before its health risks were identified—there is no expectation of increased liability costs and hence no specific incentive for precaution.[7]

Controversy over both the efficiency and equity effects of liability has particularly focused on nonpecuniary damages (punitive damages and compensatory damages for pain and suffering). Critics argue that large nonpecuniary damages are awarded arbitrarily and unpredictably, with little connection to the actual harm or to the character of the injurer's conduct. In that view, such damages are not only inequitable but also inefficient: arbitrary and unpredictable awards do not provide incentives for precaution but do raise costs, thereby distorting price signals. Critics further argue that nonpecuniary damages, whether arbitrary or not, have a separate adverse effect on the distribution of risk—in particular, that liability for pain and suffering implicitly provides consumers with a form of inefficient overinsurance.[8]

6. Some indirect benefits may also arise from better distribution of risk. In principle, risk-averse consumers who expect to be compensated for injuries more fully through the liability system than they would be through their own insurance may be more willing to buy certain goods or services (space heaters, perhaps).

7. However, the mere possibility that seemingly harmless activity may later produce tort claims increases uncertainty and gives potential injurers general incentives to buy insurance, investigate possible risks, and take generic prevention or avoidance measures (such as not researching or developing new products), which may be efficient or inefficient.

8. The argument is that consumers benefit by insuring themselves against pecuniary losses, such as lost income or increased medical costs, but not against pain and suffering (as illustrated by the fact that people generally do not purchase life insurance policies for their young children). Thus, when producers expect to pay nonpecuniary damages and build the costs of those damages into the

In contrast, supporters of the liability system argue that large punitive damages can serve equity by expressing society's disapproval of behavior that reflects wanton disregard or contempt for potential victims. Such damages can also promote efficiency, they say, by providing proper incentives for the prevention of injuries that have a significant probability of going undetected. (For example, if bolt manufacturers expect the role of defective bolts to go unrecognized in four out of five accidents that their products cause, they will have inefficiently low incentives to prevent defects unless they expect to pay five times the actual damage on those occasions when they are penalized.) Supporters further argue that pain and suffering represent real losses that should be reflected in the prices of products (to send consumers efficient signals) and that limiting awards for such losses might undercompensate some injury victims.

Evidence About the Effects of Tort Liability

Without direct data or clear theoretical predictions about the incentive effects of tort liability, analysts have tried to tease out the truth statistically. However, their most detailed efforts to date, which have focused mainly on punitive damages, have not yielded conclusive results. The best available study of the effects of punitive damages in the United States found no evidence that the 46 states that allow such damages have fewer environmental or safety torts than the four states that do not allow them. However, that lack of evidence may simply reflect the limitations of the data.[9]

Given the scarcity of data on the benefits and many of the costs of the current tort system, economists cannot judge the system's efficiency. But they can answer a narrower question about its cost-effectiveness as a means of compensating injury victims. The best available data on the direct costs of tort cases suggest that victims who file claims receive an average of 46 cents from each direct dollar spent on the system (with the other 54 cents going to attorneys' fees and insurance expenses).[10] The best available data show that such transaction costs are proportionately much smaller in public insurance programs—20 percent nationwide in state workers' compensation programs (though that figure excludes spending on claimants' attorneys, which is reportedly rising) and 15 percent in the federal Vaccine Injury Compensation Program. A no-fault public insurance program for other torts would probably not lower transaction costs to those levels, in part because of the costs of establishing which injurers were responsible for particular injuries. Nonetheless, it is safe to say that the existing tort system is a relatively costly way to compensate victims and, thus, that any justifications for it must rest on its effects on deterrence, equity, or both.

Policy Options for Changing the Tort System

The controversies over the costs and benefits of the tort system have led to numerous proposals for change at the federal level. This report discusses the potential advantages and disadvantages of various policy options in qualitative terms. Those options—which were chosen to illustrate the trade-offs between efficiency and equity that lawmakers face—fall into three main categories.

Policies for reducing the scope of tort liability include options that would eliminate liability for all injuries or all "nonstranger" injuries, exempt products certified as safe by a federal regulatory body (such as the Food and Drug Administration or the Consumer Product Safety Commission), or replace tort liability with a federal compensation system for injury victims, like the present state-

prices they charge for goods and services, consumers implicitly pay a kind of insurance premium for coverage they would not otherwise choose to buy. The effect of that implicit premium and coverage is to shift wealth inefficiently—raising it in the event of an injury, but not by enough to justify the reduction in wealth in the case of no injury.

9. One key limitation is that the control group includes only four states; another is that punitive damages would not be expected to deter typical torts but only those rare ones that were egregious enough to be the subject of such damages. See W. Kip Viscusi, "The Social Costs of Punitive Damages Against Corporations in Environmental and Safety Torts," pp. 285-345, Theodore Eisenberg, "Measuring the Deterrent Effect of Punitive Damages," pp. 347-357, and David Luban, "A Flawed Case Against Punitive Damages," pp. 359-380, all in *Georgetown Law Journal*, vol. 87, no. 2 (November 1998).

10. Tillinghast-Towers Perrin, *U.S. Tort Costs: 2002 Update—Trends and Findings on the Costs of the U.S. Tort System* (2003).

level workers' compensation system and the federal fund for vaccine victims.

Policies that are more incremental in nature but that could be applied broadly to all types of torts include options that would restrict compensation for pain and suffering or punitive damages, limit fees charged by plaintiffs' attorneys, reduce the use of joint-and-several liability (under which one or a few injurers can be held responsible for paying all of the damages caused by a number of injurers), or modify the "collateral-source rule" (under which the amount of damages owed by a defendant does not take into account any benefits that an injured plaintiff has received from an insurance policy or other independent source).

Policies targeted toward particular types of tort cases include options that would create specialized courts to hear medical malpractice cases, establish minimum medical criteria for asbestos claims and perhaps set up a victims' compensation fund, tie the fees received by plaintiffs' attorneys in class-action suits more closely to benefits actually received by the class members, or allow defendants to shift more class-action cases from state courts to federal courts.

In most cases, data limitations make it impossible for CBO to determine whether a particular option would be likely to improve or reduce economic efficiency. Nonetheless, the economic perspective leads to some general conclusions that decisionmakers may wish to keep in mind as they consider proposed changes to the liability system.

- The impact on efficiency of using tort liability to try to improve on market outcomes may be either positive or negative—depending on the incentives that liability provides for potential injurers and potential victims and on how those incentives interact with incentives and constraints from other sources, such as government regulations and private insurance policies.

- Most, if not all, options for changing the tort system involve some trade-offs. In particular, policies that seem desirable on efficiency grounds may be problematic from the equity perspective, or conversely.

- Federal involvement in an area governed predominantly by state law may be justified by its benefits for interstate commerce, but it limits state innovation and experimentation (as well as the ability of U.S. residents to "vote with their feet" by choosing to live under one state's liability regime rather than another's).

- Because the efficient solution is the one that minimizes the sum of several different costs, which may vary in their relative importance, different policies may be appropriate for different types of tort cases.

CHAPTER

1

Introduction

Injuries have many causes, including economic activities: consumers are injured or killed by defective products, workers are hurt on the job, train passengers are injured by derailments, and patients are harmed by medical errors. Markets provide broad incentives to control the number and costs of such injuries. For example, employers can save on wage costs by making jobs less hazardous; drivers with good safety records pay lower insurance premiums; and enhanced safety features can give a product a marketing advantage over its competitors. In addition, the insurance market responds to people's desire to reduce the financial uncertainty associated with potential injuries.

Society uses three tools to augment the safety incentives and insurance opportunities provided by the market: regulation, public compensation programs, and tort liability. In particular, the U.S. tort liability system is intended to reduce the number of injuries—by providing incentives for individuals and firms to take appropriate care—and to compensate those who are harmed.[1]

"Tort" is defined very broadly in law as an injury to "one's person, reputation or feelings" or damage to "real or personal property."[2] Tort liability is the court-enforced obligation of a "tortfeasor" (injurer) to pay for a victim's losses. The concept of tort liability evolved as a generalization of various specific types of injuries—including trespass, deceit, slander, and assault and battery—some of which generally occur outside the context of economic activity. Even today, tort law's diverse origins are reflected in a complex and heterogeneous body of common law. One example of that complexity is the boundary line between tort law and contract law. Notwithstanding the broad definition of a tort, injuries caused by a breach of contract are generally addressed under contract law—with the exception of injuries involving medical malpractice or defective or dangerous products, which are addressed as torts even when the parties have an explicit contract.

Tort law is almost exclusively contained in state law, and the large majority of tort cases are filed in state courts. Not surprisingly, therefore, most past efforts to reform the tort liability system in the United States have taken place at the state level. In particular, most states have adopted one or more reforms favoring defendants during the past 30 years—especially in 1986, when a perceived insurance crisis led to 41 new state laws.[3] The courts have also taken action at various times: recently, for example, the U.S. Supreme Court reiterated an earlier ruling that the Due

1. The aims of the tort system are sometimes also said to include providing a forum for the less privileged to be heard and punishing egregious behavior.

2. Bryan A. Garner, ed., *Black's Law Dictionary*, 7th ed. (St. Paul, Minn.: West Group, 1999), pp. 1496-1497.

3. Those reforms included limits on nonpecuniary damages, reductions in the scope of joint-and-several liability, and offsets for benefits from collateral sources (which are discussed in Chapter 5).

Process Clause of the Constitution establishes limits on punitive damages.[4]

Still, many critics of the current tort system say that additional federal action is needed for several reasons. At the general level, they argue that the system's costs are too high, particularly because of excessive "transaction costs" (mainly compensation to plaintiffs' and defendants' attorneys) as well as excessive and arbitrary awards for noneconomic losses ("pain and suffering") and for punitive damages. Such high costs sometimes have perverse negative effects on safety, they argue—for example, by discouraging firms from conducting safety research that could create a legal "paper trail" or by raising the prices of risk-reducing goods and services, such as medical care. Critics also contend that plaintiffs frequently bring frivolous lawsuits when they know that the defendant is inclined to settle out of court to avoid the costs of litigation.

The tort system's critics also take issue with specific types of cases. They argue that medical malpractice claims are contributing to a crisis in the cost and availability of certain health care services, that claims for exposure to asbestos by people who show no evidence of illness are burdening the courts and pushing firms into bankruptcy, and that misuse of the class-action mechanism is allowing local judges and juries who are biased against distant corporate defendants to bring verdicts that have damaging national implications.

Supporters of the current tort system question the factual basis of some of those criticisms. They note that the number of tort cases filed nationwide has been falling since 1996. Moreover, they say, large awards for punitive damages are rare and are often reduced before payment is made. They further argue that the costs of the tort system are worthwhile given the system's contributions to the social goals of compensating victims, holding injurers responsible for their actions, and improving safety. Supporters of the present system also maintain that proposed reforms are generally too broad and that fewer negative consequences would occur if the Congress allowed the states and the judiciary to address any real problems that exist.

The Congress has modified tort law several times in the past, although its actions have generally focused on torts that spring from a particular cause or affect specific industries. For example, the General Aviation Revitalization Act of 1994 exempted manufacturers of small planes from liability for crashes if the planes are more than 18 years old and not used in scheduled service. In addition, federal compensation programs that have been created for victims of vaccine injuries and the September 11 terrorist attacks limit the ability of people receiving compensation to sue for damages.[5]

This primer looks at the tort system from an economic perspective: it discusses the factors that influence whether tort liability improves or reduces economic efficiency and analyzes, in qualitative terms, the likely effects of some reform initiatives. In principle, tort liability can provide incentives for potential injurers and victims to take precautions, thus reducing injury rates. In practice, however, implementation problems can reduce the strength and value of those incentives to the point that liability decreases efficiency and may even have net negative effects on safety. Although available evidence about the tort system is too limited to support many firm conclusions, it does indicate that the system is more costly than other methods of compensating victims. Thus, an economic perspective suggests that changes to the system should focus on improving the incentives it provides, lowering its costs, or both.

4. The Court held that punitive damages must be "both reasonable and proportionate to the amount of harm to the plaintiff and to the general damages recovered." It also alluded to rough limits on the ratio of punitive damages to compensatory damages in cases involving only economic losses. *State Farm Mut. Automobile Ins. Co. v. Campbell*, 538 U.S. ___ (2003).

5. For a summary of some federal tort reform laws, see Henry Cohen, *Federal Tort Reform Legislation: Constitutionality and Summaries of Selected Statutes*, CRS Report for Congress 95-797A (Congressional Research Service, updated May 2, 2003).

CHAPTER

2

An Overview of the U.S. Tort System

Most legal scholars agree that the scope of liability in the U.S. legal system has expanded dramatically in the past three decades. That expansion began early in the 20th century with a growing acceptance of the notion that more extensive tort liability would serve to compensate injured parties and reduce the level of accidents. Although no complete set of data is available, limited data call attention to several prominent features of the current tort litigation landscape—that the vast majority of tort claims are settled out of court, that state courts handle the bulk of torts, and that different types of torts have different impacts on litigants and on the tort system.

The Expansion of Tort Liability in the United States

U.S. tort law is based primarily on common law—in which judicial rules are developed on a case-by-case basis by trial judges—rather than on legislation. Tort liability is assigned using two basic standards: strict liability and negligence. Under strict liability, injurers are held fully liable for their victims' losses without regard for whether they were actually negligent or intended to harm anyone.[1] Under a negligence standard, by contrast, injurers are held liable only if they failed to meet a certain standard of care. According to legal scholars, a number of important developments have increased the scope of liability for torts in the United States.

Early English tort law, the antecedent of U.S. tort law, was chiefly concerned with making injurers pay for the losses of their victims, with little emphasis on fault or negligence.[2] That standard was used in the United States until the 19th century, when U.S. common law established negligence as the basis for tort liability. However, strict liability continued to apply in certain cases, such as injuries caused by wild animals kept as pets or damage to crops caused by trespass of domestic animals.[3] Some scholars argue that the requirement for plaintiffs to show that defendants had been negligent effectively limited the scope of the U.S. tort system.[4]

The turn of the 20th century saw public policy increasingly emphasize victim compensation and accident reduction. The enactment of workers' compensation laws—which established a public insurance system aimed at low-

1. Strict liability—sometimes called "liability without fault"—is based on the breach of an absolute duty to make something safe. See Bryan A. Garner, ed., *Black's Law Dictionary*, 7th ed. (St. Paul, Minn.: West Group, 1999), p. 926.

2. See Stuart Speiser and others, *The American Law of Torts,* vol. 1 (Rochester, N.Y.: Lawyers Cooperative Publishing Co., 1983), pp. 144-145.

3. Ibid., pp. 144-145, note 96.

4. See, for example, George L. Priest, "The Modern Expansion of Tort Liability: Its Sources, Its Effects, and Its Reform," *Journal of Economic Perspectives*, vol. 5, no. 3 (Summer 1991).

ering employers' payments while making workers' recovery of damages automatic—played an important role in the evolution of tort law and policy.[5] Before workers' compensation programs, the only remedy that injured workers had was to prove their employers negligent through the tort system. Workers favored legislation instead because they often had been unable to recover damages or had experienced delays or high costs when they had been successful. For their part, employers favored legislation because it limited their liability and made payments predictable.[6] That shift away from tort law to a public compensation system led to more thought about how tort liability could be improved or better applied in other types of cases.

By the 1940s, legal scholars had begun to think about two ways in which the tort system could serve the wider goal of enhancing social welfare. First, they saw the economic concept of "cost internalization" as a tool for reducing accident rates: if potential injurers know they will be held liable for accidents, they will take appropriate action to avoid liability. In that view, by awarding damages to compensate victims, tort law would serve as a mechanism to ensure that potential injurers faced the appropriate future costs of their actions.[7] Second, some scholars argued that the tort system could provide a kind of accident insurance for victims. They did not focus on the possibility that an expanded liability system could increase carelessness on the part of potential victims, nor did they adopt any of the methods that traditional insurance policies use to deal with that problem.[8] Rather, they focused exclusively on the distributional goal of relieving victims of the burden of accident losses and spreading that burden across a broader population.

One area in which those concepts proved appealing in practice was product liability.[9] Historically, product liability was dealt with either as a breach of warranty under contract law or as a tort subject to the negligence standard. Under contract law, recovery in such cases was limited to repair and replacement of the product; under tort law, recovery was limited by the difficulty of proving negligence. In the 1960s, the courts moved rapidly toward a standard of strict liability for defective products; in 1964, that standard was accepted and recommended by the American Law Institute in its second *Restatement of the Law* volume on torts. By the mid-1970s, most states had adopted provisions that were either identical or similar to those in the *Restatement.*[10]

5. The first workers' compensation law was enacted in 1908 to cover certain federal civilian workers. By 1920, most states had workers' compensation laws; today, all states and the District of Columbia have their own programs. See Cecili Thompson Williams, Virginia P. Reno, and John F. Burton Jr., *Workers' Compensation: Benefits, Coverage, and Costs, 2001* (Washington, D.C.: National Academy of Social Insurance, July 2003), p. 6.

6. Depending on the state, workers' compensation requires employers to purchase insurance from either private sources or a public insurance fund, unless they can prove the ability to self-insure. Employers are responsible for benefit payments specified by state statute for on-the-job injuries regardless of who is at fault.

7. From society's perspective, the optimal level of accident avoidance is the point at which the total cost of additional avoidance is equal to the total additional benefits obtained. However, without cost internalization, an individual firm does not take losses to accident victims into account and thus underprovides accident avoidance, because the costs outweigh the private benefits. Tort liability works by aligning the private benefits of accident avoidance with the social benefits. Markets for products may also lead firms to internalize the costs of accidents when consumers are well informed about the products and the risks of injuries do not fall on third parties.

8. See the discussion in Priest, "The Modern Expansion of Tort Liability," pp. 31-50. Those scholars also did not note that using the tort system to provide insurance could adversely affect the supply of goods and services by raising companies' costs.

9. Early attempts to figure out how the tort system could be used to internalize costs in the case of automobile accidents failed because identifying which of the parties should be held liable for such an accident is generally difficult.

10. Strict liability for product defects can be seen as an evolution of negligence and warranty law. Gary T. Schwartz, in "New Products, Old Products, Evolving Law, Retroactive Law," *New York University Law Review*, vol. 58, no. 4 (October 1983), pp. 796-852, points to the fundamental "high correlation between product defect and manufacturer negligence, making the issue of negligence not worth the costs and uncertainties of litigation." Judging defective products under strict liability rather than negligence reduces plaintiffs' burden of proof. In particular, a plaintiff need not show exactly what happened inside the factory, only that the product is defective.

In addition, the concept of negligence has undergone significant reinterpretation over time, according to legal scholars. The law now takes into account the fact that manufacturers often have more ability than consumers to avoid accidents; thus, it is more likely to view failure to take inexpensive action as negligence or to attach liability to indirect or partial contribution to an injury.

Characteristics of the Tort System Today

Getting a complete picture of the state of the U.S. tort system is difficult because no data are available that cover all of the tort cases brought in the various jurisdictions across the country. However, the National Center for State Courts (NCSC) provides some data on trends in civil filings in general-jurisdiction courts in several states.[11] It also conducts periodic surveys of civil trials in the nation's 75 largest counties for the Bureau of Justice Statistics (BJS). In addition, data about cases disposed of in federal court are available from the Administrative Office of the U.S. Courts.

In 16 states consistently tracked by the NCSC, tort filings in general-jurisdiction courts grew from 189,520 in 1975 to 260,745 in 2000, which appears to support the common view that the number of tort cases is rising. But controlling for population growth in those states indicates that tort filings relative to population declined by 8 percent over that period—from 230 per 100,000 residents in 1975 to 212 in 2000.[12] Additionally, total tort filings in those 16 states were relatively constant from 1986 to 1996 and have shown a downward trend since then, falling from 320,976 filings in 1996 to 260,745 in 2000.

In drawing inferences about the tort system as a whole, however, it is important to note several limitations of the available information.

- Data do not exist for those tort disputes that do not go to trial, because the details of settlements are usually private.[13]
- Collecting consistent data between the various jurisdictions is difficult. The overwhelming majority of tort filings occur at the state level, and the structure of state courts and the laws under which they operate differ from state to state. Moreover, those courts have not tended to view keeping records on the details of case outcomes as being central to their mission.
- Both anecdotal and statistical evidence about damage awards can be misleading because the amount of damages actually paid can be reduced after a trial.[14]
- Overall trends can be misleading because various categories of torts have different economic impacts, and the timing and disposition of mass torts (cases involving large numbers of people) can significantly skew the numbers.

Settlement Versus Trial

The majority of tort disputes never reach a trial verdict. For example, of the 41,696 tort cases that were terminated in U.S. district courts in fiscal year 2000, only 3 percent

11. Although all states have at least one court of general jurisdiction, 44 states have limited-jurisdiction courts that hear certain types of cases, such as small claims, traffic, or probate cases. See Neal Kauder, *Examining the Work of State Courts*, vol. 1, no.1 (Williamsburg, Va.: National Center for State Courts, August 1995).

12. Data for the early years of that period may not be complete, but that would only sharpen the finding of a decline. See Brian J. Ostrom, Neal B. Kauder, and Robert C. LaFountain, eds., *Examining the Work of State Courts, 2001: A National Perspective from the Court Statistics Project* (Williamsburg, Va.: National Center for State Courts, 2001), with accompanying spreadsheets available at www.ncsconline.org/D_Research/csp/2001_Files/2001_Tort-Contract_Tables.xls.

13. The NCSC data are limited to the number of court filings; they do not give details about cases. They also cover only a subset of states. Another possible source of data on the outcomes of tort cases is insurance company records—since a large percentage of tort awards are paid by defendants' insurers—but companies do not regularly make those records available.

14. Many, if not most, court awards are negotiated among the parties after trial, are reduced by the judge, or are subject to statutory reductions, such as caps on damages. For example, in the widely reported case involving a person scalded by a cup of McDonald's coffee, the trial court reduced the plaintiff's $2.7 million punitive damage award to $480,000 (three times the compensatory damages).

were decided in trials.[15] The NCSC similarly reports that "[t]he vast majority of all [state] tort cases are disposed through some form of settlement, with only 3 percent of all tort matters resulting in a jury trial."[16] Litigants have mutual incentives to save on litigation costs by settling out of court. They avoid uncertain trial outcomes and delays and can agree to keep settlements confidential.[17] In some cases, settlements may be reached through alternative methods of dispute resolution, such as voluntary arbitration or mediation.

Generally, details of civil disputes settled before a trial are not reported to the courts and hence are not included in publicly available data. Those data therefore show only part of the picture—there may be important differences between cases that go to trial and cases that settle out of court.[18] For example, cases that go to trial probably involve larger dollar amounts, on average. Nevertheless, trial verdicts set precedents for all cases and thus affect the incentive to settle by signaling the value and probability of success to future litigants.[19]

Where Are Tort Cases Heard?

The vast majority of tort filings occur in state courts. In 2000, more than 700,000 torts were filed in state general-jurisdiction courts, compared with only about 37,000 in federal courts, the Congressional Budget Office (CBO) estimates.[20] Liability standards are not uniform among the various jurisdictions. For example, the extent to which damages may be reduced if the injured party contributed to the accident differs among states. In addition, a small number of local courts have been described as "class-action magnet courts" and criticized for being biased toward plaintiffs.[21]

U.S. district courts have jurisdiction in civil cases when a case deals with a federal question, the federal government is either a defendant or plaintiff, or the case involves "diversity of citizenship."[22] Of the tort cases that were terminated by trial in federal courts in fiscal year 2000, 72 percent involved diversity of citizenship, 18 percent in-

15. Congressional Budget Office calculation based on "Civil Terminations, 2000," *Federal Court Cases: Integrated Data Base* (Federal Judicial Center, Washington, D.C.), dataset no. 117, available from the Inter-university Consortium for Political and Social Research at www.icpsr.umich.edu/cgi/archive.prl?study=8429.

16. Kauder, *Examining the Work of State Courts*, p. 2.

17. Also, in some circumstances, compensatory damages are not taxable but punitive damages are. Therefore, plaintiffs who anticipate that the net value of a trial award will be reduced because of taxes have an incentive to settle for an amount below the expected trial award. See A. Mitchell Polinsky, "Are Punitive Damages Really Insignificant, Predictable, and Rational? A Comment on Eisenberg et al.," *Journal of Legal Studies*, vol. 26, no. 2 (June 1997).

18. George L. Priest and Benjamin Klein argue, on the basis of a model of the determinants of settlement and litigation, that disputes selected for litigation are neither random nor representative of all disputes. See Priest and Klein, "The Selection of Disputes for Litigation," *Journal of Legal Studies*, vol. 13, no. 1 (January 1984), pp. 1-55.

19. Firms such as Jury Verdict Research Inc. provide data to attorneys to help them value claims on the basis of verdicts for similar cases. Using their own private information about the probability of success, the litigants can calculate the expected return from going to trial. Thus, if a plaintiff thinks she has a 30 percent chance of winning at trial, and successful cases like hers average a trial award of $1,000, she should be willing to settle the case for $300 or more—or even a bit less if she is averse to risk.

20. The state figure is based on the information that 537,000 tort filings occurred in 2000 in general-jurisdiction courts in 30 states tracked by the National Center for State Courts and that those states contain 72 percent of the U.S. population. According to the Administrative Office of the U.S. Courts, 36,586 tort cases were filed in fiscal year 2000; see Administrative Office of the United States Courts, *2002 Annual Report of the Director: Judicial Business of the United States Courts* (2003), Table C-2A, p. 132, available at www.uscourts.gov/judbus2002/appendices/c02asep02.pdf. Those statistics represent the number of cases filed, not the number of plaintiffs or defendants.

21. John H. Beisner and Jessica Davidson Miller, *Class Action Magnet Courts: The Allure Intensifies,* Civil Justice Report No. 5 (New York: Center for Legal Policy, Manhattan Institute, July 2002). Some observers argue that state courts in general are biased against large corporate defendants; see, for example, Robert J. MacCoun, "Differential Treatment of Corporate Defendants by Juries: An Examination of the "Deep-Pockets" Hypothesis," *Law & Society Review*, vol. 30, no. 1 (1996).

22. Federal questions arise from interpretation and application of the U.S. Constitution, treaties, or acts of Congress. Diversity of citizenship cases are those in which no plaintiff and no defendant are citizens of the same state and at least one plaintiff seeks $75,000 or more in damages.

volved a federal question, and 11 percent involved the U.S. government as a defendant or plaintiff. Many of those tort cases did not originate in federal courts: 28 percent were removed from state courts.[23]

Categories of Tort Cases

Different types of torts pose different challenges for the goals of the liability system, so it is useful to track the trends in filings for important categories of torts. For example, overall statistics on torts can be substantially driven by developments in mass torts. The General Accounting Office found that asbestos litigation accounted for half of the growth in tort filings that occurred in federal courts between 1974 and 1986.[24] Although tort filings as a whole have fallen significantly since 1996, that overall trend masks important developments in key categories of torts.

The major areas of tort litigation, based on their share of total tort trials completed in the general-jurisdiction courts of the 75 largest U.S. counties in 1996, are automobile-related torts (49 percent), premises liability (22 percent), and medical malpractice (12 percent).[25] Many of the common categories of torts pose few policy problems. For example, automobile torts often have low awards: a median jury award of $18,000 for winning plaintiffs in state courts in the 75 largest counties in 1996, compared with a median award of $31,000 for all torts *(see Table 1)*.

In contrast, torts that have received the most public attention—such as product liability cases (including asbestos litigation) and medical malpractice cases—often involve larger stakes and have more significant effects on courts' resources, victims' compensation, the viability of businesses, and insurance premiums. Winning plaintiffs in state courts received a median award of $309,000 in asbestos cases and $286,000 in medical malpractice cases in the 75 largest counties in 1996. Moreover, about 20 percent of medical malpractice awards and 16 percent of product liability awards (other than in asbestos-related cases) were at least $1 million, compared with only 6 percent of state courts' awards for all torts. (Although punitive damages were infrequently awarded in medical malpractice and asbestos cases, they were also higher than the average for all torts: median amounts of $250,000 and $110,000, respectively, compared with $38,000 for tort cases overall.)[26] At the federal level, medical malpractice cases terminated by trial in U.S. district courts in 1996 had a median final award of $252,000.

Policymakers and the business community have been concerned about the increasing costs of asbestos litigation. Researchers at RAND estimate that claims for asbestos-related compensation totaled $54 billion through 2000, with estimated future costs ranging from another $145 billion to $210 billion.[27] They also identified 67 bankruptcies related to asbestos litigation through 2002, up from three through 1982. Adding to that concern is the latency that occurs in the onset of asbestos-related disease, which makes it difficult to predict firms' exposure to liability and to ensure adequate compensation for victims who have yet to file claims.[28]

23. Congressional Budget Office calculations based on "Civil Terminations, 2000," *Federal Court Cases: Integrated Data Base* (Federal Judicial Center, Washington, D.C.), dataset no. 117, available from the Inter-university Consortium for Political and Social Research at www.icpsr.umich.edu/cgi/archive.prl?study=8429.

24. General Accounting Office, *Extent of "Litigation Explosion" in Federal Courts Questioned*, GAO/HRD-88-36BR (January 1988).

25. Department of Justice, Bureau of Justice Statistics, *Tort Trials and Verdicts in Large Counties, 1996*, NCJ 179769 (August 2000). The same data also show that tort cases typically involve individuals suing individuals (42 percent of all torts) or individuals suing businesses (39 percent).

26. Those medians exclude cases with awards of zero.

27. Presentation by Deborah Hensler at the U.S. Chamber of Commerce seminar "Understanding Asbestos Litigation: The Genesis, Scope, and Impact," Washington, D.C., January 23, 2003, available at www.legalreformnow.com/resources/012303.pdf. See also Stephen J. Carroll and others, *Asbestos Litigation Costs and Compensation: An Interim Report* (Santa Monica, Calif.: RAND Institute for Civil Justice, 2002), available at www.rand.org/publications/DB/DB397/DB397.pdf.

28. Another factor contributing to the concern has been a recent surge in new asbestos cases. New filings in U.S. district court for asbestos cases involving personal injury or product liability rose from 5,041 in fiscal year 2000 to 26,818 in 2002 (see Administrative Office of the United States Courts, *2002 Annual Report of the Director*, Table C-2A). But federal cases are only a portion of total claims (which also include state and trust fund claims), and the number of new cases (which represent old exposures now coming to light rather than new exposures) fluctuates greatly from year to year.

Table 1.

Characteristics of Tort Cases Decided by Trial in State and Federal Courts, 1996

	Percentage of Cases Won by Plaintiff	Median Award (Dollars)	Percentage of Awards $250,000 or More	Percentage of Awards $1 Million or More
All Tort Cases				
State	48.2	31,000	16.9	5.8
Federal	45.8	139,000	38.1	14.6
Automobile Accidents				
State	57.5	18,000	8.7	3.4
Federal	59.7	100,000	37.4	11.6
Medical Malpractice				
State	23.4	286,000	51.0	20.2
Federal	39.8	252,000	54.3	22.9
Asbestos				
State	55.6	309,000	50.6	12.1
Federal[a]	40.0	465,000	50.0	0
Product Liability Other Than Asbestos				
State	37.1	177,000	41.2	16.3
Federal	26.6	368,500	62.0	24.0

Source: Congressional Budget Office based on Department of Justice, Bureau of Justice Statistics, *Tort Trials and Verdicts in Large Counties, 1996*, NCJ 179769 (August 2000), and "Civil Terminations, 1996 and 1997," *Federal Court Cases: Integrated Data Base* (Federal Judicial Center, Washington, D.C.), dataset nos. 103 and 104, available from the Inter-university Consortium for Political and Social Research at www.icpsr.umich.edu/cgi/archive.prl?study=8429.

Notes: State numbers are based on trials in general-jurisdiction courts in the 75 largest counties in the United States in calendar year 1996 (calculated from data for fiscal years 1996 and 1997). Federal numbers are based on trials in U.S. district courts in calendar year 1996.

Data on awards exclude cases won by defendants and those with awards of zero.

a. There were only two federal asbestos cases with monetary awards in 1996.

Asbestos cases also differ from other torts in the number of firms affected. The median number of defendants in asbestos litigation was 18, compared with a median of one defendant in tort cases overall.[29] Over time, the targets of asbestos suits have expanded from the original manufacturers of asbestos-related products to include customers who may have used those products in their facilities. According to RAND, the total number of defendants in asbestos litigation rose from 300 in 1982 to more than 6,000 in 2000.[30]

Recent data show no growth in the total number of medical malpractice tort claims, but the size of awards has increased. Median payments for medical malpractice claims at trial rose from about $100,000 in 1990 to over $300,000 in 2001, according to the Physician Insurers

29. Department of Justice, *Tort Trials and Verdicts in Large Counties, 1996*.

30. Carroll and others, *Asbestos Litigation Costs and Compensation*.

Association of America.[31] (BJS data from the nation's largest counties show an increase in median awards in state courts from $201,000 in 1992 to $286,000 in 1996.)[32] That rise coincides with increasing malpractice premiums for doctors, which critics blame for leading to a reduction in the availability of health care in some parts of the country.

Another set of tort claims that concerns policymakers is cases filed using the class-action procedure, in which a small number of plaintiffs represent a larger group of people who were similarly affected by the same product or tort. Class-action cases are designed to address relatively small but numerous losses for which individual suits would be impractical. However, when the class is large enough, even claims that are trivial individually can have a significant effect on particular firms and even whole industries. Limited data are available on class actions, but those cases are more likely than other torts to be filed in federal court. For example, a RAND study estimated that during the 1995-1996 period, 40 percent of reported class-action decisions arose in federal court, whereas CBO estimates that less than 5 percent of all torts are filed in federal court.[33]

31. Data supplied to the Congressional Budget Office by the Physician Insurers Association of America in spring 2003.

32. See Department of Justice, Bureau of Justice Statistics, *Tort Trials and Verdicts in Large Counties, 1996,* and *Civil Jury Cases and Verdicts in Large Counties*, NCJ 154346 (July 1995).

33. Deborah R. Hensler and others, *Class Action Dilemmas: Pursuing Public Goals for Private Gain* (Santa Monica, Calif.: RAND Institute for Civil Justice, March 1999).

CHAPTER

3

Tort Liability as a Tool for Achieving Efficiency and Equity

Different observers describe tort liability as serving various combinations of purposes—among them, compensation, deterrence, risk spreading, and punishment or retribution. In economic terms, those various purposes can be related to the overarching social goals of efficiency and equity. The efficiency goal is to allocate scarce resources so as to maximize the total benefits available to society; the equity goal is to distribute those benefits in accord with some (necessarily subjective) conception of fairness or justice. Metaphorically speaking, efficiency involves making the pie as big as possible, and equity focuses on slicing it appropriately.

The Complexity of the Policy Problem

If there were just a single injury for policymakers to consider, then once that injury had occurred, the only relevant policy questions would pertain to equity. That is, the size of the pie would already be determined by the fact of the injury, and the remaining issues would involve what punishment (if any) the injurer deserved and what compensation (if any) the victim deserved.[1]

In reality, of course, policymakers are concerned not with a single injurious event but with many such events over time—which gives rise to the efficiency question of minimizing the total cost associated with future injuries. That total includes not only the costs of the injuries themselves (in medical care, pain, decreased worker output, and so on) but also:

- Prevention costs (the costs of efforts to avoid injuries, which tend to raise the prices of goods and services);
- Transaction costs (the costs of legal and administrative resources, such as attorneys' fees);
- Indirect costs to the economy (for example, from the disruptions caused by layoffs and bankruptcies); and
- Uncertainty costs (the burden of uncertainty for potential victims and potential injurers—since driving the rate of injuries down to zero would be ruinously expensive, if not impossible—as well as the transaction costs of reducing that burden through insurance or other risk-spreading mechanisms).

That sketch of the policy goals suggests the difficulties that policymakers face in seeking to address the personal and social costs of injuries. One potential problem is trade-offs between equity and efficiency. For example, a particular conception of fairness might hold that certain victims should not be considered responsible for exercising some forms of care, although it would be more efficient if they

1. The equitable levels of punishment and compensation need not be the same, even in the case of fines and monetary awards. Depending on the facts of the case and on one's conception of justice, the victim might be felt to deserve more or less than the injurer should pay, with any difference coming from or accruing to the government.

Table 2.

Summary of Major Tort Liability Standards

	Components of Efficiency						
	Standard Provides Incentives for Efficiency in						
Standard	Injurer's Degree of Care?	Scale of Injurer's Activities?	Victim's Degree of Care?	Scale of Victim's Activities?	Distribution of Risk?	Transaction Costs	Implications for Equity
Strict Liability	Yes	Yes	No	No	No (Overinsures nonpecuniary losses)	High	Compensates all victims; bundles unwanted insurance for nonpecuniary losses into product prices
Strict Liability with Comparative Negligence	Yes	Yes	Depends on extent of reduction in compensation to negligent victims	No	No (Overinsures nonpecuniary losses)	High	Compensates non-negligent victims (partially compensates negligent victims); bundles unwanted insurance for non-pecuniary losses into product prices
Negligence	Depends on the efficiency of the legal standard of due care	No	Yes	Yes	No (Overinsures nonpecuniary losses, though less so than strict liability since non-negligent injuries are not compensated)	High	Nonnegligent injurers not held liable; some victims uncompensated

Source: Congressional Budget Office.

did so. Even within the single goal of efficiency, policymakers may have trouble identifying the best approach, given that each approach might have different effects on injury costs, prevention costs, transaction costs, indirect costs, and uncertainty costs and that the relative importance of those costs might vary from one type of injury to another.

Under ideal market conditions, much of the policy problem—the part concerning injuries associated with economic activities—could be solved easily. In particular, market forces would achieve the efficiency goal for such injuries by minimizing the sum of the related costs: producers and employers would respond to consumers' and workers' preferences by taking all cost-effective measures to make their products and workplaces safer, and risk-averse people would buy insurance to eliminate the financial uncertainty surrounding the remaining risks. Any equity goals involving additional compensation of injury victims could be met through a government program of income transfers.[2]

2. Even in that simpler world, society would still face the issue of minimizing the costs of "stranger" injuries—those unrelated to any economic transaction, such as injuries caused by a release of toxic gases from a chemical plant. Chemical companies certainly have incentives to maintain their reputations, but there is no presumption that such indirect effects accurately reflect the interests of potential victims.

In reality, the results produced by market forces can only approximate the efficient outcome, and the accuracy of that approximation depends in large part on how well potential victims understand the risks they face.[3] Some risks (such as long-latency illnesses that result from exposure to new chemical substances) become apparent only years or decades after they are introduced into the economy. Other risks, though recognized by experts, are largely unknown or are not accurately taken into account because of biases in the way people process information about risk and uncertainty.

Incomplete information or understanding about risk raises the possibility that government intervention—through regulations or liability rules—can improve on the efficiency of market outcomes. There is no guarantee that it will do so, however. Whether it does depends on the strengths and weaknesses of the particular interventions, as discussed below.

Liability Rules in Principle

The various forms of strict-liability and negligence standards used by the courts encourage potential injurers to exercise care and result in compensation to victims in different ways and to different extents. Neither type of standard, however, reliably induces optimal levels of care and participation by both injurers and victims, even in theory. Also, both types are prone to inefficiency in their effects on the distribution of risk.

In its purest form, strict liability compensates all victims except those judged to have caused the injury themselves or to have knowingly and voluntarily "assumed the risk" of exposure to a particular hazard. Strict liability thus gives potential injurers an incentive to make all socially efficient changes in the level or form of their activities, because they know they will face the full cost of almost any resulting harm *(see Table 2)*. It may have a very different effect on potential victims, however. To the extent that they expect to be fully or almost fully compensated for their losses (which is more likely to occur in cases involving only property damage, not personal injury or death), strict liability gives potential victims little or no incentive to take reasonable precautions of their own.

In cases alleging defective products—a major category of tort claims subject to strict liability—U.S. courts typically do not apply strict liability in its pure form. Instead, they use a doctrine of comparative negligence.[4] Under that variant of the standard, the compensation paid by an injurer is reduced if the victim is found to have contributed to the injury through his or her own negligence, as defined by some explicit or implicit legal standard. (In 1996, about 16 percent of all awards in tort trials in the nation's 75 largest counties were reduced because of the plaintiff's own negligence. Those reductions averaged 43 percent.)[5] Taking comparative negligence into account is likely to improve the efficiency of strict liability to the extent that plaintiffs' negligence is a broader concept than plaintiffs' causation (or assumption of risk) and thus gives potential victims an incentive to avoid more types of careless behavior.[6] But it still does not give them cause to

3. It also depends on how well potential injurers understand the costs of their opportunities to reduce injury risks (that is, their "production functions" for safety). In practice, that factor is probably less of a constraint on the efficiency of market outcomes than is lack of understanding of risk on the part of potential victims and thus is less likely to provide a good rationale for government intervention.

4. Comparative negligence is also widely applied in types of tort cases that are judged under a negligence standard. Its use in cases judged under strict liability may seem incongruous: in principle, a defendant may be liable even in the absence of any negligence against which to compare the plaintiff's negligence. But current law essentially infers some degree of negligence (whether of design, manufacture, or labeling) whenever a plaintiff shows that a defective product caused an injury.

5. Department of Justice, Bureau of Justice Statistics, *Tort Trials and Verdicts in Large Counties, 1996*, NCJ 179769 (August 2000).

6. The impact of that incentive depends on potential victims' awareness of it and on their expectations about how their behavior would affect the compensation they would receive if injured. If they expect to receive some compensation despite engaging in "mild" negligence, they may not be encouraged to make all cost-effective changes in their behavior. (Some states allow a defense of contributory negligence rather than comparative negligence; under that defense, negligent victims have their compensation eliminated rather than reduced.) Conversely, the possibility of reduced compensation under comparative (or contributory) negligence may be irrelevant if potential victims face risks of death or other injuries for which compensation would be greatly inadequate.

adjust the scale of their risky activities, since standards for due care do not consider scale itself. For example, a negligence standard may dictate that bicyclists wear helmets and obey traffic rules, but it will not address how often they ride.

The same analysis applies in reverse when injurers are judged according to a negligence standard. If the standards of due care are set at ideal levels, potential injurers will make all efficient adjustments in the way they conduct their activities. In addition, potential victims who expect injurers to escape liability through the "safe harbor" of due care have an incentive to take all efficient precautions because they will bear the costs of any injuries. However, the standards for care typically do not provide any incentives about the scale of potential injurers' activities. Thus, for example, a manufacturer whose rate of production defects is low enough to be considered nonnegligent will have no incentive to consider the costs of injuries associated with its defects when it decides how many units to produce.

Some observers point to another shortcoming of liability rules: by compensating victims for pain, suffering, and other nonpecuniary losses, those rules provide a kind of excessive and unwanted insurance that distributes risk inefficiently. (That issue applies less strongly to negligence, to the extent that injurers are able to avoid paying damages by meeting the standards of due care.)[7]

The argument is that pecuniary losses such as medical expenses and lost income increase a victim's need for money (technically, the marginal utility of an additional dollar), but nonpecuniary losses do not and hence are not worth insuring against. Persuasive evidence for this argument is the fact that insurance policies bought directly by consumers typically do not cover events such as the death of a young child. Notwithstanding the great suffering they would feel, consumers apparently do not find it worthwhile to buy coverage that reduces their wealth now (by the amount of the insurance premium) in order to increase it in the event of such a loss. But liability awards for pain and suffering shift wealth in precisely that fashion—the prices that a firm charges for its goods and services reflect the future liability claims it expects to pay on them, and thus consumers fund the awards through higher prices that reduce their preinjury wealth. Whether such shifts are equitable depends on subjective judgments (on the one hand, they help compensate victims; on the other hand, they benefit a few at the expense of the many). Nevertheless, they do appear to distribute risk inefficiently.[8]

Liability Rules in Practice

The efficiency of liability rules is restricted not only by theoretical limitations but also by practical problems. The most obvious such problem is the transaction costs of the legal system—particularly, the costs of plaintiffs' and defendants' lawyers. Underlying that problem is the fundamental issue that information (in this case, information about the cause of a tort injury) is generally incomplete and costly to acquire. The lack of complete information allows room for disagreement between plaintiffs and defendants and encourages attorneys to expend effort to unearth and document additional information favorable to their case.

Incomplete information also allows errors to occur. Some torts go unchallenged, unjudged, or undercompensated; conversely, some defendants pay claims for losses for which they were not truly liable or in excess of the harm they caused. For example, one study of medical malpractice torts found that only 1.5 percent of people classified as likely victims of medical error sued and that relatively few of those who did sue appeared to have legitimate

7. In principle, if potential injurers are able to avoid liability under a negligence standard, then consumers face the opposite problem of being underinsured against the risks of pecuniary losses. Consumers can solve that problem, however, by buying their own insurance to achieve the desired level of protection.

8. Note, however, that failing to incorporate the expected costs of nonpecuniary losses into the price of a good or service would not be efficient either. The risks of pain and suffering associated with an item are real components of its cost and should be reflected in its price; otherwise, consumer demand for the item may be inefficiently high. Ideally, potential victims would make their decisions about consumption on the basis of an item's full cost but would receive some kind of payment to mitigate the impacts of the nonpecuniary costs on their wealth. One proposed mechanism for doing that—known as unlimited insurance subrogation—is discussed in Chapter 5.

claims.[9] Such errors reduce the equity of the liability system. They may also reduce its efficiency (as discussed more fully below) by prompting potential injurers to overspend or underspend on precautions or to try to avoid liability in ways that do not reduce the actual risk of injuries.

Concerns about such errors underlie much of the debate about punitive damages. One efficiency-based rationale for punitive damages is that they serve an important corrective role for torts that have a significant probability of going undetected. Potential injurers who expect to be held liable only one-third of the time will not have efficient incentives to exercise care unless they expect to pay treble damages on the occasions when they are held responsible.[10]

Conversely, punitive damages may reduce efficiency if they do more to create errors than to correct them. Critics argue that punitive damages are awarded arbitrarily, at the whim of juries not guided by any clear or coherent standards, and are often erroneous. As evidence, they cite cases in which the punitive damages were tens or hundreds of times larger than the compensatory damages or were awarded even though the injurer had good reason to believe that it was not negligent (in other words, that its behavior satisfied a relevant standard of due care). Whether such criticisms are valid for only a few cases or for punitive damages in general is an open question in need of further study.[11]

Errors—and information problems more broadly—also underpin much of the debate about the class-action procedure. By combining many claims that cover similar factual ground, that procedure reduces transaction costs that could otherwise make it impractical for plaintiffs to pursue claims that may be large as a whole but are small individually. However, critics argue that class actions are susceptible to erroneous judgments—in part because plaintiffs' attorneys have wide latitude to bring them in certain courts that are thought to be biased against out-of-state corporate defendants—and that such errors can have nationwide implications. In some cases, plaintiffs' attorneys may be able to leverage the possibility of such errors to achieve lucrative settlements of even frivolous claims, if defendants are sufficiently averse to risk. Also, because class members may have little incentive or opportunity to exercise effective oversight, plaintiffs' attorneys in such cases may pursue settlements that benefit them but are not in the best interest of their clients.[12]

A final problem associated with limited information is the difficulty of setting the standard of due care in a negligence rule at an efficient level. Courts often defer to a community's customary standard of care in defining negligence, and a custom that has stood the test of time in a competitive market may be a good approximation of the efficient solution.[13] But customary standards may be hard to apply or nonexistent in cases of new risks or new products. Moreover, any general rule may not be detailed

9. Those findings were based on an analysis of 30,000 medical records from New York State in 1984; see A. Russell Localio and others, "Relation Between Malpractice Claims and Adverse Events Due to Negligence," *New England Journal of Medicine*, vol. 325 (July 25, 1991), pp. 245-251. The analysis showed that only 14 percent of claimants appeared to have legitimate cases; however, that percentage was based on a limited sample (47 claims).

10. In principle, punitive damages could also improve efficiency by correcting for compensatory awards that do not fully reflect the amount of harm done. In practice, however, cases in which large punitive damages are awarded also tend to involve large compensatory awards.

11. The most directly relevant empirical study to date examined the occurrence of punitive damages in a year's worth of trials from 45 of the nation's 75 largest counties. It found a strong statistical relationship between the level of punitive damages, when awarded, and the level of compensatory damages, but it did not attempt to identify factors that would explain which cases (of a given type) yielded awards for punitive damages and which did not. Thus, the study left unresolved the question of whether the decision to award punitive damages is arbitrary. See Theodore Eisenberg and others, "The Predictability of Punitive Damages," pp. 623-661, and A. Mitchell Polinsky, "Are Punitive Damages Really Insignificant, Predictable, and Rational? A Comment on Eisenberg et al.," pp. 663-677, both in *Journal of Legal Studies*, vol. 26, no. 2 (June 1997).

12. Deborah R. Hensler and Thomas D. Rowe Jr., "Beyond 'It Just Ain't Worth It': Alternative Strategies for Damage Class Action Reform," *Law and Contemporary Problems*, vol. 64 (Spring/Summer 2001), available at www.law.duke.edu/journals/lcp/articles/lcp64dSpringSummer2001p137.htm.

13. The presumption that customary standards of care are relatively efficient does not apply to stranger injuries, such as automobile accidents, which occur outside any market context.

enough to take into account the specific opportunities and constraints facing each potential injurer and potential victim and thus may set the bar too high for some and too low for others.

Should Tort Rules Be Set at the Federal or State Level?

Although tort cases are primarily governed by state law, the Congress has broad Constitutional authority to change tort rules under its power to regulate interstate commerce.[14] Federal intervention in tort law can have two main benefits. First, it can lower costs by giving manufacturers and other nationwide businesses a single set of standards under which to operate. Advocates of greater federal involvement argue that state preeminence may have been appropriate when most goods were produced locally, but it is inefficient now that firms typically manufacture products in a few locations to sell nationally. Second, whereas state legislatures and courts have an incentive to favor state residents, and thus to design or interpret their legal rules to benefit in-state plaintiffs at the expense of out-of-state defendants, the federal government can potentially take the broad view (in economic terms, "internalize the externality") and craft rules that take equal account of the interests of all parties nationwide.

Supporters of a more decentralized approach argue that federal involvement in state tort law may not provide equal treatment of all costs and benefits. Rather, it may reflect concentrations of political influence, which can tilt toward plaintiffs at one time and defendants at another. In that view, maintaining state preeminence in tort law reduces the risk of nationwide errors in policy. It also allows greater scope for state innovation and experimentation and a wider range from which people can choose the type of liability regime that appeals to them—one with more extensive protection of injured parties or one with lower costs for businesses (and hence, presumably, lower prices for consumers).

14. For a discussion of that general authority and some exceptions to it, see Henry Cohen, *Federal Tort Reform Legislation: Constitutionality and Summaries of Selected Statutes*, CRS Report for Congress 95-797A (Congressional Research Service, updated May 2, 2003).

Tort Liability Versus Insurance and Regulation

As noted above, tort liability is only one of the tools that society uses to try to supplement market mechanisms, such as contracts and private insurance. Other tools are regulation and public compensation programs (such as the workers' compensation system). All of those policy tools have strengths and weaknesses—as do markets—so using them in combination may be beneficial. However, the interactions among different tools and the market can be complex and even counterproductive.[15]

The interplay between liability and private insurance is perhaps the most complicated. From the point of view of potential victims, tort liability acts as a partial substitute for their own insurance—the more comprehensive the set of injuries for which they receive tort damages, the fewer the injuries ultimately compensated by their own coverage. Conversely, from the perspective of potential injurers, liability increases uncertainty, leading many of them to buy liability insurance to control that uncertainty. The extensive use of such insurance makes analyzing the efficiency of tort liability more complicated, because it may undermine potential injurers' incentives to exercise care. The degree to which it does so hinges on the precautions (if any) that insurance companies require as a condition for providing coverage and also on the thoroughness of their underwriting. The more they tailor their premiums to policyholders' specific practices or experiences, the more incentive potential injurers still have to take cost-effective precautions.

The interactions between liability and regulation are perhaps less complex—but in that case also the two can be

15. The relative use of those different policies varies significantly among countries. The United States relies more heavily on tort liability than 11 other industrialized nations do, judging from the estimated shares of gross domestic product that those countries spend on their tort systems; see Tillinghast-Towers Perrin, *U.S. Tort Costs: 2000—Trends and Findings on the Costs of the U.S. Tort System* (February 2002). The different policy mixes may reflect underlying differences in national conditions (such as in the homogeneity or diversity of the industrial sector) and values (such as in conceptions of equity or willingness to trade equity for efficiency).

complements as well as substitutes.[16] In particular, tort lawsuits can be used as a private mechanism for enforcing regulations, particularly when government agencies lack the resources to monitor compliance or prosecute violations themselves. Such lawsuits may be explicitly authorized by statute, as in the case of some civil rights laws. Alternatively, judges may decide that tort claims are an appropriate means by which to carry out the intent of particular statutes. For example, a court may allow a tort claim of deceit under a statute that makes it a crime to roll back an automobile's odometer.[17]

As alternatives to each other, regulation is a more centralized policy tool than liability is. The centralized approach may be more or less efficient for particular classes of injuries—on the one hand, it tends to have lower transaction costs; on the other hand, the regulations it produces can only be as good as the information available to the central decisionmakers. Whereas tort claims arise after specific injuries occur, efficient regulation requires before-the-fact information about risks of injury, types of precaution, and the costs and benefits associated with particular regulatory standards. In addition, the more diverse that a given group of potential injurers is, the greater the amount of information that will be necessary to craft regulations that appropriately reflect the group's various circumstances. In practice, the efficiency of regulations can also be lessened by political factors, such as pressure from interest groups or excessive influence from the regulated entities.

16. For a more extensive discussion of the potential complementarities and conflicts, see Susan Rose-Ackerman, "Product Safety Regulation and the Law of Torts," in Janet R. Hunziker and Trevor O. Jones, eds., *Product Liability and Innovation: Managing Risk in an Uncertain Environment* (Washington, D.C.: National Academies Press, 1994), pp. 151-158, available at www.nap.edu/openbook/0309051304/html/151.html.

17. For a discussion, see American Law Institute, *Restatement of the Law Second, Torts* (Philadelphia: ALI, 1979), section 874A.

CHAPTER

4

The Costs of the Tort System

The efficiency of the tort system is difficult to measure because information about its benefits is so sparse. In particular, data on the damages avoided because of additional precaution are not readily available. Some costs associated with tort liability have been measured, however, and can be used in a limited evaluation of the cost-effectiveness of tort liability as a mechanism for compensating victims. Understanding the nature and magnitude of tort costs can also help policymakers identify options that would tend to control those costs while enhancing the benefits of the tort system.

Defining the Costs of Tort Liability

The most easily measured "costs" of the liability system are its direct costs—that is, those incurred by plaintiffs, defendants, and their insurance companies in litigating and settling specific claims, as well as the court costs that are ultimately paid by taxpayers. For the purposes of policy analysis, however, that measure of costs is too large in one respect and too small in another.

It is too large in that some direct "costs" merely shift money from injurers to victims and thus are not true costs to society as a whole. In economic terms, payments that do not involve any use of resources to produce goods or services are called "transfer payments." Those that do involve using resources for production are known as "real resource costs" (also "social costs" or simply "costs"). Specifically, the portion of a settlement or judgment that goes to the plaintiffs is a transfer payment. The portion that goes to the plaintiffs' attorneys, in contrast, is a real cost because it reflects the value of the resources (attorneys' time, office space, equipment, and so on) devoted to that case and thus not available for other uses.[1]

Conversely, measures of direct costs are too small for policy purposes in that they naturally exclude indirect costs—those associated not with specific claims but with actions that businesses and consumers take or forgo because of the incentives of the liability system as a whole. Indirect costs include various kinds of real resource costs, such as:

- The costs of precautions taken by potential injurers,
- The opportunity costs (forgone value) of goods and services that potential injurers withdraw from the market or do not create because of liability concerns,
- The opportunity costs of goods and services that consumers do not buy because of liability-induced price increases, and

1. The statement that all legal costs are real resource costs assumes that lawyers' services are priced correctly in the market. To the extent that legal fees are kept artificially high by some market imperfection or governmental interference, they include both resource costs and transfer payments.

- The disruption costs of layoffs and bankruptcies caused by liability problems.[2]

Indirect costs are not necessarily bad: from the perspective of efficiency, the question is whether they yield benefits larger than the costs.

Evidence About the Costs of the Tort System

The most comprehensive estimates of tort liability costs —which cover only direct costs—come from studies by Tillinghast-Towers Perrin, an actuarial and management consulting firm.[3] Those estimates take advantage of the fact that most tort costs are paid through the insurance industry, in the form of legal costs to defend policyholders, benefits paid to victims and their attorneys on behalf of policyholders, and internal costs for handling claims. Thus, Tillinghast uses financial data from the insurance industry to estimate insured costs for all types of policies except medical malpractice insurance. (Those costs are estimated separately using the firm's proprietary database of state-level costs, controlling for the changing mix of insured versus self-insured providers.) Finally, Tillinghast estimates self-insured costs (again, except for medical malpractice) on the basis of various specialized studies. Because of a lack of data, the estimates exclude awards and settlements that cannot be insured in particular states (such as those for contract and shareholder litigation or for punitive damages) and certain extraordinary self-insured costs, such as those of the tobacco settlements.[4]

By that definition of costs, the U.S. tort system cost a total of $205.4 billion in 2001, Tillinghast estimates. That figure represented 2.04 percent of gross domestic product—the largest share among the 12 industrialized countries that Tillinghast investigated.[5] Of that amount, 46 percent constituted transfer payments to plaintiffs: 22 percent for economic damages and 24 percent for noneconomic damages. The other 54 percent represented true costs: transaction (procedural) costs for plaintiffs' attorneys (19 percent), defense costs (14 percent), and insurance companies' administrative costs (21 percent).[6]

Estimates for most of the indirect costs of the tort system do not exist—which is not surprising given that many of those costs are difficult to observe. For example, even firms that keep track of their safety-related spending would probably have trouble identifying the share driven by tort liability rather than by regulation or other factors. One notable exception to the lack of estimates of indirect costs comes from a recent study released by the U.S. Chamber of Commerce, which estimated that asbestos liabilities have caused $0.6 billion to $2.1 billion in disruption costs from bankruptcies and layoffs.[7]

Are Tort Costs Excessive?

Costs can be considered excessive if they do not contribute positively to either efficiency or equity. Even transfer payments may be excessive costs in that sense. Although transfers do not use real resources directly, the incentives they provide can have real costs that reduce efficiency. In addition, transfers that are arbitrary or otherwise unfair can reduce equity.

---

2. Indirect costs may also include transfer payments, but this discussion focuses only on real resource costs.

3. Tillinghast-Towers Perrin, *U.S. Tort Costs: 2002 Update—Trends and Findings on the Costs of the U.S. Tort System* (2003).

4. The estimates also omit courts' administrative costs, but those are thought to be relatively small. An estimate from the RAND Institute for Civil Justice cited by Tillinghast-Towers Perrin puts those costs at 1 percent of total direct costs.

5. Tillinghast-Towers Perrin, *U.S. Tort Costs: 2002 Update*. In its previous report, dated February 2002, Tillinghast included estimates of tort costs in other countries. That report stated that in 2000, tort costs equaled 1.9 percent of gross domestic product in the United States, compared with 1.7 percent in Italy and 1.3 percent in Germany—the next two closest countries.

6. Administrative costs are insurance companies' overhead expenses. Tillinghast says it includes those expenses because they are "real costs, directly associated with administering the settlement of tort claims."

7. Jesse David, *The Secondary Impacts of Asbestos Liabilities* (prepared by NERA Economic Consulting for the U.S. Chamber of Commerce, January 23, 2003), available at www.legalreformnow.com/resources/012303secondary.pdf.

The Efficiency of the Tort System as a Mechanism for Compensation

On the question of whether tort costs contribute to efficiency—which is the focus of economic analysis—the available data allow a partial conclusion: even leaving aside the largely unknown indirect costs, the current tort system seems to be an inefficient way to compensate victims. As noted above, Tillinghast estimates that only 46 percent of the total direct costs of the tort system go to victims in the form of economic and noneconomic damages; 54 percent go to transaction costs. By comparison, in the no-fault compensation systems for on-the-job and vaccine-related injuries, administrative costs make up only about 20 percent and 15 percent of total costs, respectively.[8]

Those comparisons are not entirely apt, however. The administrative costs of those compensation systems exclude spending on claimants' attorneys—which has reportedly grown in the workers' compensation system as the regulations governing it have become more complex. Moreover, linking injuries to particular injurers (so their premiums can be adjusted to reflect their own track record, as the workers' compensation system does) would be more difficult with torts in general. Nonetheless, given the large percentage differences between the tort liability system and no-fault compensation systems, it seems safe to conclude that the tort system costs more than does an available alternative method of compensating victims.

Some types of torts clearly have little impact on deterring injuries; virtually their entire value to society is as a mechanism for compensating victims. Asbestos torts are an example: the injurious actions generally took place decades ago, and asbestos is now in limited use (as a combined result of litigation and government regulation), so today's cases serve no role in deterring additional asbestos injuries. The same reasoning applies to any torts that deal with injuries whose source was unknown at the time.[9] For such torts, liability costs are indeed inefficient.

The Efficiency of the Tort System as a Mechanism for Deterrence

In the more typical case of torts that are intended to provide deterrence as well as compensation, economists have not reached a consensus about whether costs are efficient. The tort system may conceivably improve efficiency, despite its high transaction costs, if it is particularly effective in reducing the number and severity of injuries. Such effectiveness has not been demonstrated, however.

One key issue is the relationship between actual costs to victims and the liability costs that are faced by injurers. In a situation in which potential injurers anticipate paying an extra dollar for every additional dollar of injuries or transaction costs they cause, they have the right incentive to take cost-effective steps to reduce future costs.

However, potential injurers may expect to pay more or less than one extra dollar in liability for each additional dollar of social costs they cause. If liability awards exceed actual injury losses—for example, because of punitive damages—potential injurers may be motivated to overspend on precaution (provided they can identify enough promising ways to do so). As an example, suppose a firm expects to pay two dollars in liability for every dollar of actual social costs it produces. In that case, it will perceive investments in precaution to be twice as valuable as they are to society as a whole, and thus it will have an incentive to spend up to two dollars for every additional dollar in actual costs saved. All of the spending that returned less than one dollar per dollar from society's standpoint would reduce the net savings from precaution, making it less likely that tort costs on the whole were efficient. Ironically, the inefficiency associated with excessive precaution may result in increased risk. For instance, drug manufacturers may withdraw or withhold otherwise valuable medicines

8. Those numbers are CBO's calculation of the proportion of employers' costs that are not paid out in workers' compensation benefits, using data from Cecili Thompson Williams, Virginia P. Reno, and John F. Burton Jr., *Workers' Compensation: Benefits, Coverage, and Costs, 2001* (Washington, D.C.: National Academy of Social Insurance, July 2003), and CBO's calculation of administrative costs divided by new obligations for the Vaccine Injury Compensation Program Trust Fund, using data from *Budget of the United States Government, Fiscal Year 2004*: *Appendix*, p. 409.

9. Suits over asbestos and other "hindsight torts" could conceivably help deter future injuries associated with other products by serving as cautionary examples. But once the example was well established, as seems likely with asbestos, any further suits would have negligible value as additional deterrents.

from the market, and physicians may withdraw their services.[10]

Efficiency may also suffer if potential injurers find ways to reduce their liability exposure without reducing the actual risk of injury. Such avoidance efforts typically have real resource costs but do not add to the social benefits of tort liability. That problem arises from errors in assigning liability: if injurers were held responsible for all of (and only) the injuries that they truly caused, they would have no opportunities to reduce expected liability costs without reducing actual risks. A commonly cited example is "defensive medicine," in which medical professionals conduct low-value procedures in hopes of avoiding the costs and stigma of being sued.[11]

Finally, if potential injurers expect to pay less than one dollar in liability costs per dollar of additional social costs —or, more to the point, expect to save less than one dollar per dollar of reduced social costs—they will have too little incentive to take preventive action. That situation may occur if liability judgments have a significant arbitrary component, if avoidance efforts succeed in obscuring injurers' roles in causing some losses, or if injurers insure their liability costs and the premiums they pay do not fully reflect their injury record. Underinvestment in prevention can even arise from perverse incentives that associate increased care with higher liability costs—as in the case of a company that refrains from researching ways to make its products safer lest it create a paper trail of safety-related data that could be used against it in court.[12] Whatever the cause, underinvestment in prevention has the same effect on efficiency as overinvestment: the net savings from precaution are lower than they would be in the ideal case (here, because some worthwhile opportunities are neglected), and thus they are less likely to outweigh the other costs of the liability system.

The Efficiency and Equity of Nonpecuniary Damages

Critics of the tort system have particularly questioned the deterrence benefits of nonpecuniary damages (punitive awards and compensatory awards for pain and suffering). They argue that large nonpecuniary damages cannot provide useful incentives for precaution because they are awarded in a subjective, arbitrary, and unpredictable way, with little connection to the actual harm or, in the case of punitive damages, to the character of the injurer's conduct. In that view, such awards are inequitable as well as inefficient. Indeed, the Supreme Court has ruled that punitive damages violate the Due Process Clause of the Constitution if they are not "both reasonable and proportionate to the amount of harm to the plaintiff and to the general damages recovered."[13]

The accuracy of that characterization of nonpecuniary damages is a matter of some debate. Supporters of the status quo argue that large awards for punitive damages can promote efficiency by sending appropriate signals for precaution in regard to torts that have a significant proba-

10. Whether or not potential injurers overreact (they may not if they lack effective opportunities to reduce their liability), excessive awards can increase risk in a second way: through decreased consumption of risk-reducing goods and services, such as medical care. Consumption of such goods and services is likely to decline as their prices are driven up by liability costs or as price increases for products in general leave consumers with less real income.

11. Most of the available evidence about defensive medicine comes from anecdotes or conjectural surveys of practitioners. That evidence does not rule out doctors' own financial incentives under fee-for-service payment systems as an alternative explanation for "unnecessary" tests. However, Daniel Kessler and Mark McClellan have shown that passage of state laws limiting liability for doctors led to lower spending for certain heart procedures. See Kessler and McClellan, "Do Doctors Practice Defensive Medicine?" *Quarterly Journal of Economics*, vol. 111, no. 2 (May 1996), pp. 353-390. In addition, Lisa Dubay and coauthors found in one study that areas with a high risk for medical malpractice claims tended to have a higher incidence of cesarean births, but without significantly better birth outcomes. In another study, they found a lower incidence of prenatal care in areas with a high risk for medical malpractice claims. See Dubay and others, "The Impact of Malpractice Fears on Cesarean Section Rates," *Journal of Health Economics*, vol. 18 (1999), pp. 491-522, and "Medical Malpractice Liability and Its Effect on Prenatal Care Utilization and Infant Health," *Journal of Health Economics*, vol. 20 (2001), pp. 591-611.

12. See François J. Castaing, "The Effects of Product Liability on Automotive Engineering Practice," in Janet R. Hunziker and Trevor O. Jones, eds., *Product Liability and Innovation: Managing Risk in an Uncertain Environment* (Washington, D.C.: National Academies Press, 1994), pp. 77-81, available at www.nap.edu/openbook/0309051304/html/77.html.

13. *State Farm Mut. Automobile Ins. Co. v. Campbell*, 538 U.S. ___ (2003).

bility of escaping detection and judgment. Moreover, they say, large punitive damages can serve equity by punishing egregious behavior on the part of large injurers. Supporters further argue that noneconomic losses such as pain and suffering are as real as economic losses (albeit harder to quantify), so setting artificial limits on awards for such losses may undercompensate some injury victims and may produce some product prices that are inefficiently low because they do not fully reflect the products' true risks.

Economists have tried to shed empirical light on the question of the efficiency of tort costs, focusing primarily on punitive damages. However, the limited data have not yielded a compelling answer. A 1998 study investigated the deterrent effects of punitive damages by comparing the four states that prohibit such damages with the 46 states (and District of Columbia) that allow them. The study found no statistically significant differences in deterrent effects—and in many cases, differences of the "wrong" sign—for more than a dozen indicators of environmental and safety risks.[14] The author of the study posited two arguments to explain the lack of an effect: that punitive damages are awarded too randomly to influence behavior, and that federal regulations and market forces other than liability are stringent enough to leave no room for additional deterrence. However, two follow-up papers suggested that the statistical results of that study could merely reflect limitations of the data. Those papers argued that four states do not provide a strong basis for comparison and that punitive damages could be serving their intended purpose of deterring the most egregious torts—which by definition are relatively rare—without having a discernable impact on overall injury rates.[15]

Conclusions

In short, the current state of data and economic analysis do not allow CBO to judge whether the costs of the tort system are efficient or excessive on the whole.[16] What is clear, however, is that those costs are large enough to be significant for the U.S. economy. That fact helps raise the question of whether changes to the current tort system could reduce the system's costs without undermining its benefits.

14. The indicators included toxic-chemical accidents, toxic-chemical accidents involving injury or death, reductions in releases of toxic chemicals (to surface waters and to all media), total deaths, "medical misadventure deaths," total insurance premiums, and premiums for medical malpractice, product liability, and other liability. See W. Kip Viscusi, "The Social Costs of Punitive Damages Against Corporations in Environmental and Safety Torts," *Georgetown Law Journal*, vol. 87, no. 2 (November 1998), pp. 285-345.

15. Theodore Eisenberg, "Measuring the Deterrent Effect of Punitive Damages," pp. 347-357, and David Luban, "A Flawed Case Against Punitive Damages," pp. 359-380, both in *Georgetown Law Journal*, vol. 87, no. 2 (November 1998).

16. A 2002 report by the President's Council of Economic Advisors investigated the burden of liability costs on the economy, but it did not provide new information about the incentive effects of tort liability. Rather, the report sketched three alternative scenarios, each of which assumed that certain categories of the direct costs estimated by Tillinghast have no impact on the behavior of potential injurers and are thus "excessive." See Council of Economic Advisors, *Who Pays for Tort Liability Claims?: An Economic Analysis of the U.S. Tort Liability System* (April 2002).

CHAPTER

5

An Overview of Policy Options for Changing the Tort System

Various scholars and policy advocates have proposed altering the tort liability system to reduce what they see as excessive transaction costs and other problems associated with it. Those proposals are too numerous for all of them to be discussed here. Instead, this chapter examines a number of policy options to illustrate the range of choices available to lawmakers. The chapter outlines each option's potential implications for efficiency and equity. For reasons of space, however, it cannot analyze any one option in full detail. (For example, it does not consider the effects on state law or the potential transition problems associated with a particular change, nor does it discuss the many possibilities for combining policies that are not mutually exclusive.)

The options discussed here can be grouped according to their general approach. The first approach would greatly reduce the scope of the tort system and rely more heavily on other tools to control the costs of injuries. The second group contains options that are more incremental in nature but that could be applied broadly to the universe of torts. The final set comprises options targeted toward types of tort claims that have raised particular policy concerns, such as claims arising from medical malpractice or asbestos exposure and those litigated as class actions.

In all three groups, most of the proposals can be seen as addressing one or more of the fundamental barriers to efficiency discussed in Chapter 3:

- The difficulty of giving both potential injurers and potential victims incentives to choose the efficient form and scale of their risk-related activities;
- The added difficulty of optimally distributing (insuring) the risks that remain after efficient precautions have been taken; and
- Problems relating to the cost and scarcity of information, including transaction costs, errors in judgments and in settlements, and inefficient standards for due care.

Other options respond to issues that arise from broader aspects of the legal system, such as the perceived problem that some locally elected judges are biased against out-of-state corporate defendants.

Options for Reducing the Scope of Tort Liability

The policy changes in this group—which involve replacing some or all types of tort liability with private or public insurance—generally go well beyond the kinds of proposals now being considered by the Congress. They are included here because they help clarify the strengths and weaknesses of the tort system or provide useful comparisons with other options.

Replacing Tort Liability with Private Insurance

Some academic economists favor the approach of eliminating tort liability, except perhaps for injuries between "strangers" (such as injuries from automobile accidents).[1] Potential victims would rely to a greater extent on their own insurance for protection against injury risks. In cases in which potential injurers could cost-effectively reduce those risks, they would be motivated to do so to the extent that they could gain a marketing advantage—by advertising the safety of their products or by offering injury compensation in a warranty, purchase contract, or the like.[2] Some increases in government regulation might also occur.

From the standpoint of efficiency, eliminating tort liability would have several desirable implications, although it would fall short of the ideal. It would give potential victims the incentive to take all cost-effective precautions and to obtain the optimal amount of risk spreading through insurance or other compensation contracts. And provided that the insurance and contract terms were clear enough, the amount of litigation would decline significantly, reducing both transaction costs and the inefficiencies associated with erroneous judgments. However, this approach would weaken incentives for potential injurers to exercise cost-effective forms of care (at least those not required by regulation) and could increase inefficiencies associated with imprecise or too-stringent regulation.

From the standpoint of equity, the implications of shifting primary responsibility for injury costs to victims could be considered both good and bad. Lower liability-related costs for businesses should lead to lower prices for many consumer goods and services and reduce the extent to which consumers are implicitly forced to pay for unwanted insurance for nonpecuniary damages. But victims would usually get compensation only for pecuniary losses, and those who had not bought insurance might get no compensation at all. Moreover, injurers would pay compensation only to the extent that they had contracted in advance to do so, and in cases of subtle, delayed, or indirect harm, some injurers' roles might go undetected because few, if any, plaintiffs' attorneys would be working to identify the causes of injuries.

A narrower variant of the same basic idea would eliminate liability only for those products (or features of products) that have been certified as safe by a federal body, such as the Food and Drug Administration, the National Highway Traffic Safety Administration, or the Consumer Product Safety Commission. Many of the arguments for and against completely eliminating tort liability would apply here as well, at least qualitatively. For example, the same efficiency and equity implications would follow from making consumers bear the risk of using the relevant products. The main immediate difference from the standpoint of efficiency is that focusing on products that satisfied federal safety regulations would presumably limit the extent of any increase in injury risks. From the perspective of equity, removing the threat of liability from firms whose products met federal standards might be particularly appropriate. Over time, however, this variant could result in a greatly expanded role for federal regulators—with potentially significant consequences for both efficiency and equity—as firms and industries seeking to exempt their products from liability pushed to broaden the scope of federal safety standards.

Replacing Tort Liability with Public Insurance

Another variant of the previous approach would eliminate (or greatly restrict) tort liability as described above but replace it with a public insurance system, like the present workers' compensation system or the fund for vaccine victims. In this option, victims would receive compensation from a government fund according to a fixed schedule based on the type of injury they had and other relevant factors.[3] To finance the fund, businesses would pay "experience-rated" premiums that reflected the previous record of injuries associated with their products. (Companies would ultimately pass on the costs of those premiums to their customers, workers, or investors in the form of higher prices, reduced wages, or lower returns on capi-

1. See, for example, Paul H. Rubin, *Tort Reform by Contract* (Washington, D.C.: American Enterprise Institute, 1993).

2. Contracting in advance for compensation is not possible between parties that had no previous contact or relationship, which is one argument for maintaining tort liability for stranger injuries.

3. Public insurance funds have also been proposed in narrower contexts; an option that focuses on asbestos injuries is discussed later in this chapter.

tal, respectively.) Depending on the details of the proposal, nonprofit organizations and state and local governments might also participate. But cost considerations would probably make it impractical to rate and collect premiums from individuals, so the injuries they caused might still be handled through the tort system.

Proponents of this variant hope that by standardizing the amount of compensation awarded for similar injuries, this approach would cap or reduce punitive damages and compensatory awards for pain, suffering, and other nonmonetary losses. The effects of reducing such nonpecuniary awards would be qualitatively similar to (though not as large as) the effects of simply eliminating tort liability. Again, potential victims would have better incentives to take efficient precautions, and risk would be distributed more efficiently (because consumers would not be implicitly paying for so much unwanted insurance for nonpecuniary damages). However, some injurers might not face sufficient penalties, and some victims might not receive full compensation for their pain and suffering.

Other implications of the public insurance approach flow from its shift away from litigation to an administrative mechanism. For example, one key argument made for the approach is that it would significantly reduce transaction costs from the 54 percent estimated under the current tort system. (However, transaction costs would probably remain higher than the 20 percent estimated for state workers' compensation programs because of higher costs for such things as determining which injuries were compensable and associating injuries with particular injurers.) Conversely, one argument against public insurance is that the schedule of damages might not do justice to individual cases. Another is that in some cases of subtle, indirect, or delayed harm—such as cancers with long latencies caused by exposure to a particular chemical— victims might not recognize that they had suffered a compensable injury, since there would be few, if any, plaintiffs' attorneys working to identify injury causes. In addition, this option would represent a sharp departure from current practice for injuries that are judged under a negligence standard. Providers of medical care, for example, are now held liable only for injuries considered to result from negligence; but with this option, all compensable injuries to patients under their care would be reflected in their assessed premiums for the public fund.

The incentives for potential injurers to exercise care might be more or less efficient under a public insurance program than they are now. For a firm to be encouraged to take all cost-effective precautions, its assessed premiums would need to reflect all of the effects of its actions on expected future injury costs, and the experience rating would probably not be that thorough. However, even if the new incentives fell on the low side, the error could be smaller than it is now if current incentives are inefficiently high because of mistaken or excessive trial awards.

Options for Reforming the Tort System as a Whole

Changes that would maintain the basic structure of the tort system can take many forms. The options discussed here focus on nonpecuniary damages, attorneys' fees, joint-and-several liability, and payments from "collateral sources," such as victims' insurance policies. (Those options are summarized in *Table 3*.) All of the policy changes could be applied to the broad universe of tort claims or, alternatively, to one or more subsets of particular concern.

Controlling Nonpecuniary Damages

As noted above, one goal of people who advocate public insurance as an alternative to tort liability is to control nonpecuniary damages. That goal can be achieved in other ways, however—most directly, through statutory limits or bans on those damages. Many states impose such restrictions, either in general or for particular types of torts. In addition, several federal bills considered in recent years have proposed limits in specific contexts. Examples from the current Congress include the Asbestos Compensation Fairness Act of 2003 (H.R. 1586), which would prohibit punitive damages in asbestos cases, and the HEALTH Act of 2003 (H.R. 5) and the Common Sense Medical Malpractice Reform Act of 2003 (H.R. 321), which would limit noneconomic compensation in medical malpractice cases to $250,000 and punitive damages to twice the economic damages or $250,000, whichever was greater.

A second, less centralized way to reduce nonpecuniary damages would be to allow producers of goods and services to specify in advance the extent of damages they would pay in the event of an injury. Products carrying limits on damages could be offered at lower prices (because

Table 3.

The Primary Effects of Some Broad Options for Tort Reform

Option	Effects on Efficiency		Effects on Equity
	Positive	Negative	
Control Nonpecuniary Damages			
Cap or prohibit nonpecuniary damages	Improves allocation of risk (by reducing implicit over-insurance); may reduce distortions of safety incentives if current damages are excessive or arbitrary	May undermine incentives for care and encourage excessive consumption of risky products if current damages are appropriate	Consumers are not forced to buy as much bundled insurance for non-pecuniary losses; depending on the character of existing damages, lower payments by injurers may reduce excessive judgments or punish injurers inadequately, and lower awards to victims may represent inadequate compensation or smaller windfalls
Allow buyers and sellers to agree in advance to limit liability damages	Same as above	Same as above	Same as above, except that incomplete compensation to victims may be viewed as equitable if it follows voluntary, informed choices by consumers
Allow unlimited insurance subrogation	Improves allocation of risk (by reducing implicit over-insurance) and incentives for care by consumers	No major negative effects	Consumers can effectively undo the bundled insurance for nonpecuniary losses; injurers still pay such damages, but the payments go to victims' insurance companies rather than to victims
Control Attorneys' Fees			
Cap contingent fees	Reduces nuisance suits	Makes it harder for some victims with difficult claims to find representation	Defendants face fewer claims for both legitimate and nuisance suits; some victims receive cheaper representation but others cannot find representation
Promote early offers and limit fees when such offers are made and accepted	Reduces transaction costs for some cases; may reduce nuisance suits	May indirectly make it harder for some victims (though fewer than above) to find representation if attorneys cannot subsidize difficult cases with profits from easy cases	Defendants may face fewer nuisance suits and perhaps fewer legitimate suits; some victims receive cheaper representation but others (though fewer than above) cannot find representation

(Continued)

their expected costs would be lower), and the forces of supply and demand would determine the options available in the market. That approach could lead to the elimination of nonpecuniary damages for risky products—if, as argued in Chapter 3, consumers would rather have lower prices than actuarially fair insurance for such damages. In principle, the courts could implement this option on their own, without legislation, by enforcing damage-limitation contracts in injury cases. They have not done so up to now, however (which is why producers today cannot offer consumers lower prices in exchange for reduced liability). Moreover, Congressional action could allow a faster and clearer transition to the new system.[4]

4. Rubin, *Tort Reform by Contract*.

Table 3.
Continued

Option	Effects on Efficiency		Effects on Equity
	Positive	Negative	
Restrict or Eliminate Joint-and-Several Liability	May reduce transaction costs if the inability to target injurers with deep pockets discourages some suits; may make incentives for care more or less efficient	May increase transaction costs if plaintiffs pursue larger numbers of defendants; may make incentives for care more or less efficient	Injurers with deep pockets pay lower damages and transaction costs; victims get less compensation and may pay higher transaction costs
Offset Payments from Collateral Sources	May reduce erroneous findings of liability if some verdicts are motivated by concern that plaintiffs need money for their injuries (such as for medical care)	Reduces incentives for care to the extent that potential injurers expect losses to be covered by other sources	Injurers pay lower damages; victims are not doubly compensated, nor are victims' insurance companies and other collateral sources reimbursed for the benefits they provide

Source: Congressional Budget Office.

The efficiency effects of letting producers and consumers limit tort liability damages through contracts would be similar to those of capping or prohibiting damages by statute. Again, to the extent that nonpecuniary damages were reduced, uncertainty would be distributed more efficiently, but lower prices for risky products would probably lead to inefficiently high consumption unless consumers took the risks into account in their decisions about purchases.

The equity implications of the two approaches would differ, however. According to some conceptions of equity, limiting victims' access to compensation for pain and suffering is problematic if it is done by legislative fiat but not if it results from the victims' own choices (provided those choices are adequately informed and voluntary).

A third option focusing on nonpecuniary damages—known as unlimited insurance subrogation (or substitution)—would allow insurance policies to specify that the insurance company would collect all of a liability award or settlement paid by an injurer for an injury covered by the victim's policy.[5] In contrast, the limited subrogation allowed under current law lets a company receive only the portion of an award that is necessary to reimburse it for benefits paid under its policy.

Assuming that consumers continued to insure themselves only for pecuniary losses, the result of this option would be that insurance companies could collect more than they paid out whenever one of their policyholders was awarded punitive damages or compensation for pain and suffering (or pecuniary damages in excess of the policy's benefits). The expected value to insurers of the net proceeds from such cases would reduce their costs, and in a competitive market, they would pass on the savings to consumers through the premiums they charged. In principle, the result for the average consumer would be to exactly undo the inefficient "bundled" coverage for nonpecuniary damages that is implicitly included in the prices of risky goods and services. Taking into account their savings on premiums and their restricted compensation in the event of an injury, consumers would be paying for and receiving coverage only for pecuniary damages.

Like the previous two options, unlimited subrogation would reduce the inefficiency associated with bundled insurance for nonpecuniary damages at the cost of reducing the compensation received by victims. Indeed, it would probably go farther than proposals that merely cap such

5. See David Rosenberg, *Deregulating Insurance Subrogation: Toward an Ex Ante Market in Tort Claims*, Discussion Paper 395 (Cambridge, Mass.: Harvard Law School, John M. Olin Center for Law, Economics, and Business, undated).

damages, by eliminating them for injuries covered under most, if not all, insurance policies. But unlike the previous options, it would leave injurers liable for such damages—the difference being that the awards and settlements would go to insurance companies rather than to victims.[6] Thus, potential injurers would still have an incentive to consider the full social costs of their risk-related actions, and consumers would continue to see those total costs reflected in the prices of products. In short, the unlimited-subrogation approach would not only allocate consumers' wealth more efficiently between the uninjured and injured states (again, by reducing or eliminating overinsurance for nonpecuniary damages) but would also maintain efficient incentives in product markets.

Controlling Attorneys' Fees

Typically, plaintiffs' attorneys in tort cases charge their clients "contingent" fees that are based on a percentage of any damages ultimately received from the defendants. Like nonpecuniary damages, those fees could be constrained by law. The Congress has considered various proposals that would cap such fees in specific contexts.[7]

In an ideal world without errors and information costs, attorneys would pursue only meritorious claims; thus, from the standpoint of efficiency, restricting their incentive to do so by limiting the fees they could charge would be unambiguously negative.[8] Proponents of such caps argue that in practice, however, the costs of inhibiting some legitimate claims would be outweighed by the benefits of reducing the number of "nuisance suits" (such as those filed solely to extract settlements from defendants who would face high litigation costs).[9] From the standpoint of equity, capping contingent fees would help some victims by letting them keep a larger share of the damages they collected, but it could hurt other victims by reducing their access to legal representation.

Some more-targeted versions of this approach could lessen the negative effects. Under one variant—called the "early offers" proposal—a plaintiff's attorney who charged contingent fees would be required to send claim notices in all personal injury cases; his or her fees would be capped only if the defendant made an offer within a specified time after receiving the claim notice and the plaintiff accepted the offer.[10] Because that variant would cap fees only in cases for which the plaintiff's attorney had done relatively little work, it would be likely to reduce any adverse effect on the ability of injury victims to find legal representation. Still, limiting attorneys' fees in those cases could make it harder for attorneys to take chances on meritorious but difficult cases that might ultimately yield them no income.

Restricting or Eliminating Joint-and-Several Liability

For injuries caused by more than one party, the question arises of how much liability to assign to each party. Courts generally use one of two rules in answering that question (although other approaches can be imagined). Under joint-and-several liability, any one injurer or subset of injurers can be held responsible for paying all of the damages. That individual or group often has the right to seek reimbursement from the remaining injurers. Under several liability, by contrast, the court determines the relative contribution of each injurer in causing the harm and holds each one responsible for only that proportion of the dam-

6. This approach assumes that insurance companies could secure the cooperation of their injured policyholders at trial. For a discussion of that issue, see ibid., footnote 22.

7. For example, the HEALTH Act of 2003 would allow plaintiffs' attorneys in medical malpractice cases to collect no more than 40 percent of the first $50,000 recovered in a case by all plaintiffs, 33 percent of the next $50,000, 25 percent of the next $500,000, and 15 percent of any amount above $600,000.

8. In that textbook world, the ideal approach would be to allow attorneys to buy claims from the plaintiffs for agreed-upon amounts and collect 100 percent of any settlement or judgment, since that would give them the incentive to pursue cases to the efficient extent. But under current law, such complete transfer of a claim from plaintiff to attorney (known as "champerty") is illegal. See Robert D. Cooter, "Economic Theories of Legal Liability," *Journal of Economic Perspectives*, vol. 5, no. 3 (Summer 1991), p. 20.

9. Versions of this approach that would limit contingent fees for court judgments but not for voluntary settlements would have the additional effect of giving plaintiffs' attorneys more incentive to settle. Again, that effect is clearly inefficient in a simple textbook world, but it may improve efficiency if other factors currently bias attorneys against settlement and toward trial.

10. The capped fees would increase plaintiffs' incentives to accept early offers and thus defendants' incentives to make them.

ages. In the past 20 years, many states have either eliminated joint-and-several liability under some or all circumstances or have restricted it in various ways—for example, by limiting it to certain types of damages or to injurers whose liability exceeds a certain percentage threshold.

Whether such changes have increased or decreased efficiency is not clear. Ideal incentives require joint injurers to each face liability equal to the incremental effect of their own actions, but neither joint-and-several nor several liability reliably achieves that result. To illustrate, consider a case in which the actions of two injurers are both necessary to cause harm—for example, in which each one disposes of a chemical and the two chemicals then combine to produce an explosion. Avoiding the explosion is efficient if either party could do so at a cost lower than the cost of the resulting damage. But neither injurer might take care if it expected to share liability evenly under either joint-and-several or several liability and its prevention costs exceeded 50 percent of the damage.[11]

What is clear is that several liability has two disadvantages for plaintiffs—and conversely, two advantages for defendants—relative to joint-and-several liability. First, it makes plaintiffs bear a higher share of the transaction costs. Instead of pursuing only a selected subset of the alleged injurers (often just the single party with the deepest pockets) and shifting the costs of dealing with the remaining parties to that selected group, plaintiffs must sue everyone from whom they hope to collect damages. Second, if some of the injurers are bankrupt, defunct, or otherwise unable to pay their share of the damages, several liability leaves plaintiffs partially uncompensated, whereas joint-and-several liability compensates them more fully, to the extent that other, deeper-pocketed injurers can be tapped for their fellow injurers' shares.

11. In that case, strict liability could provide efficient incentives if *each* party faced potential liability for 100 percent of the damages, rather than 100 percent for both parties combined. Negligence standards could also provide efficient incentives here; as discussed above, however, such standards are not fully efficient in general because they do not provide appropriate incentives for the scale of nonnegligent activities. See Thomas J. Miceli and Kathleen Segerson, "Joint Liability in Torts: Marginal and Infra-Marginal Efficiency," *International Review of Law and Economics*, vol. 11, no. 3 (December 1991), pp. 235-249.

Offsetting Payments from Collateral Sources

Under the law's traditional "collateral-source rule," the fact that an injured plaintiff has received benefits from some independent source—such as an insurance policy—may not be considered in determining whether a defendant should pay damages and, if so, how much. In some cases, the collateral source exercises a lien or right of subrogation and is reimbursed for the overlap between the benefits and the damages. In many cases, however, the effect of the collateral-source rule is to allow victims to receive double compensation for their injuries.

In the past two decades, many states have revised the collateral-source rule in various ways that could serve as models for federal action. Those revisions range from merely allowing collateral payments to be introduced as evidence in certain types of cases to requiring that damages be reduced to offset such payments under all circumstances. If verdict errors never occurred, there would be no clear economic rationale for such changes—efficiency dictates that injurers should face the costs of their actions (or, at least, of their negligent actions) regardless of the other benefits available to victims. However, if judges or juries sometimes wrongly find defendants liable because of conscious or subconscious concern that plaintiffs may lack the resources to deal with their injuries, then such changes may improve efficiency. In either case, it may be more equitable for injurers not to pay victims who receive collateral benefits, at least under some circumstances—which may argue for allowing information about such benefits to be introduced as evidence and considered by juries and judges.

Options for Reforming Certain Types of Torts

Most of the recent Congressional attention on tort reform has focused on specific types of claims, particularly those arising from medical malpractice or asbestos exposure and those litigated as class actions. Proposals that target those types of claims often include the application of one or more of the broad approaches discussed above, but they generally also include some options that reflect more specifically the nature of the particular claims. This section discusses some of those narrower options.

Creating Specialized Courts

Will the tort system function better if special courts are established to hear particular kinds of claims? For certain classes of difficult cases, specialized courts may yield one or both of the following benefits. First, they may achieve administrative efficiencies that will move cases through the judicial system faster or at lower cost. The pursuit of such efficiencies appears to be the main reason that 10 states (as of August 2000) have created courts focusing on business or complex litigation.[12] Second—as advocates of the creation of special courts to hear medical malpractice claims argue—assigning certain types of complex cases to judges with particular expertise in a subject may improve the quality of case outcomes.[13] The idea is that judges who have experience or specialized training can more accurately interpret scientific or technical issues (in the terms discussed in Chapter 3, lower the cost of information), provide more consistent application of the law, or both.

One potential argument against specialized courts is that to the extent that they make the process of litigation more efficient, they may encourage additional plaintiffs to bring suits. Indeed, some analysts argue that efforts to streamline asbestos cases (in part by consolidating claims for trial) "actually increased the total dollars spent on the litigation by increasing the numbers of claims filed and resolved."[14] In addition, a tension exists between using judges with special areas of expertise to improve case outcomes and the tradition and values of using nonspecialist juries.

12. National Center for State Courts, "Focus on Business and Complex Litigation Courts," *Civil Action: A Briefing on Civil Justice Reform Initiatives*, vol. 1, no. 1 (August 2000), available at www.ncsconline.org/wc/publications/Res_SpePro_CivilActionV1N1pub.pdf

13. See the remarks of Philip K. Howard before the Common Good forum, "Beyond Patients' Rights: Do We Need a New System of Medical Justice?" hosted by the AEI/Brookings Joint Center for Regulatory Studies, Washington, D.C., April 24, 2002, available at http://cgood.org/medicine/item?item_id=3390.

14. Stephen J. Carroll and others, *Asbestos Litigation Costs and Compensation: An Interim Report* (Santa Monica, Calif.: RAND Institute for Civil Justice, 2002), p. 26.

Addressing Asbestos Claims

As noted in Chapter 2, claims for injuries resulting from asbestos exposure have grown rapidly over the past three decades, have involved larger amounts of damages than the average tort case, and have been implicated in the bankruptcies of dozens of defendants. Another notable feature of asbestos claims is that a large share of the plaintiffs have not yet become sick—that is, they are not functionally impaired—but nonetheless they are subject to statutes of limitations that begin when they discover (or should have discovered) bodily evidence of exposure. Thus, one option that the Congress has considered is to specify certain medical criteria that asbestos victims would have to satisfy in order to pursue claims.[15] In effect, asbestos injury would be redefined in terms of impairment rather than exposure.

Limiting asbestos claims to those involving impairment would probably improve efficiency by reducing the number of cases and hence lowering total transaction costs. In addition, allowing injurers to avoid paying damages to people who have been exposed but are not notably impaired should have little adverse effect on the efficiency of incentives for precaution against future tort injuries. From the standpoint of equity, this option would benefit victims who are sick today by reducing the competition for court time and injurers' compensation funds. Conversely, it would impose a loss on victims who are not yet impaired, many of whom will incur higher medical costs to monitor their condition over time. Moreover, those victims would not be guaranteed to benefit if they became impaired later, because the funds available to pay claims might be greatly diminished by then.

Another option that the Congress has considered would combine the approach of setting minimum criteria for impairment and establishing a public fund that would compensate victims according to a schedule reflecting the severity of injury and perhaps other relevant factors, such as smoking history.[16] Such a fund would be a narrower

15. See, for example, the Asbestos Claims Criteria and Compensation Act of 2003 (S. 413).

16. See the Fairness in Asbestos Injury Resolution Act of 2003 (S. 1125). Another bill, the Asbestos Compensation Act of 2003 (H.R. 1114), takes an intermediate approach: like S. 1125, it would

variant of the idea of replacing tort liability with public insurance, but some of the pros and cons of the broader idea discussed above would be less relevant here. In particular, because asbestos exposures generally happened decades ago, using a public fund rather than the liability system to compensate victims would have little impact on incentives for precaution against future injuries. The main issues raised by proposals for a compensation fund are the potential savings in transaction costs and the adequacy and appropriateness of the funding sources and compensation schedule.

Addressing Class-Action Claims

Several approaches have been proposed for changing the rules that govern class-action claims. One of those approaches would broaden the "diversity of citizenship" rule to allow more cases to be removed from state court to federal court.[17] That rule—which currently states that U.S. district courts have jurisdiction in civil cases in which no plaintiff and no defendant are citizens of the same state and at least one plaintiff seeks at least $75,000 in damages—could be broadened to a greater or lesser degree. At the extreme, all cases (or perhaps all cases above some low monetary threshold) that involve at least one plaintiff and one defendant from different states could be made removable.

In a simple model of how courts work, changes to the diversity rule would at best be irrelevant—and at worst be harmful to both efficiency and equity to the extent that they inhibited some claims by raising plaintiffs' costs. But the evaluation is less clear when two complicating factors are taken into account. On the one hand, if significant problems of bias against out-of-state defendants exist in some local courts, an expanded diversity rule may improve efficiency and equity by circumventing those problems. Evidence about the highly disproportionate incidence of class-action suits in a small number of jurisdictions suggests that local bias may indeed be a significant problem.[18] On the other hand, if expanded diversity leads to lengthy delays in trying legitimate claims because federal courts have more-limited capacity than state courts do, the costs to efficiency and equity may subtract from or outweigh the benefits.

A second type of proposal targets a different perceived problem with class-action suits—namely, that plaintiffs' attorneys often act independent of any effective oversight by members of the class and collude with defendants to reach settlements that reflect their own interests rather than those of class members.[19] Proposals to address that problem attempt to bring attorneys' interests more closely in line with those of the class. One approach might be to tie the compensation of plaintiffs' attorneys to the benefits actually received by class members. (For example, in the case of a settlement that gave class members coupons for discounts on future purchases from a defendant, the attorney's compensation might be made proportional to the number of class members who used the coupons.) In principle, aligning the two sets of interests should improve both efficiency and equity. In practice, however, it might be difficult to devise rules that would be both comprehensive (and thus not easily circumvented) and flexible enough to accommodate the full range of possible circumstances.

---

establish a fund that would offer compensation to asbestos victims according to a schedule. (Both bills would allow unimpaired victims of asbestos exposure to be reimbursed for some medical monitoring costs.) But the fund would be financed on a claim-by-claim basis through settlements with or judgments against individual defendants, rather than as a public insurance program. Moreover, victims would retain the right to file claims in court instead of accepting compensation from the fund.

17. See, for example, the Class Action Fairness Act of 2003 (H.R. 1115 and S. 274).

18. John H. Beisner and Jessica Davidson Miller, *Class Action Magnet Courts: The Allure Intensifies*, Civil Justice Report No. 5 (New York: Center for Legal Policy, Manhattan Institute, July 2002).

19. For examples of seemingly abusive class-action settlements, see Trial Lawyers for Public Justice, *Class Action Abuse Prevention Project*, brochure (Washington, D.C.: Trial Lawyers for Public Justice, undated), available at www.tlpj.org/caappbrochure.pdf.