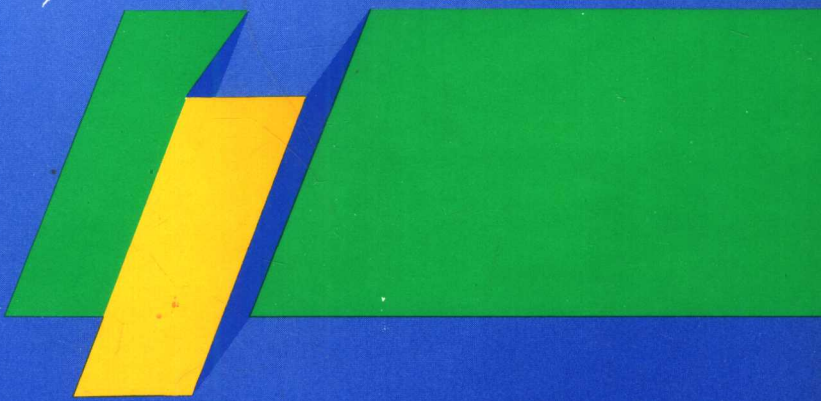
Liability

Perspectives and Policy

ROBERT E. LITAN
and
CLIFFORD WINSTON
Editors



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Foreword

In recent years the United States has witnessed an unprecedented growth in personal injury lawsuits. State and federal courts have been flooded with litigation involving medical malpractice, unsafe products, and environmental hazards. Jury awards and out-of-court settlements for medical expenses, income losses, and the pain and suffering of victims have routinely amounted to hundreds of thousands of dollars. At the same time, premiums for liability insurance have risen steeply, and some companies have refused to cover new clients or withdrawn coverage entirely. These developments have threatened the functioning of the entire civil litigation process and touched off a national debate over what should be done to bring order to our system of dealing with personal accidents and injuries. Some critics have urged fundamental reform of the civil liability system to limit awards. Others have contended that more extensive regulation of the insurance industry would reintroduce stability.

In this book Robert E. Litan, Clifford Winston, and a team of economists and lawyers evaluate the issues underlying this debate and suggest policies to ameliorate the problems of both the courts and the insurance industry. They examine the functions of tort law in providing compensation and deterring harmful behavior, the apparent liberalization of tort doctrines that has contributed to higher damage awards and affected the availability and cost of insurance, and the ways in which changes in the system have affected the provision of medical services, the development of safer products, the maintenance of safety in the workplace, and the protection of the environment. The authors also identify critical gaps in knowledge that need to be filled before any sweeping changes can be advanced. Thus, although they provide specific policy recommendations,

they are cautious about calling for radical changes, such as replacing the tort system with broad administrative compensation programs, unless sound evidence supporting such programs becomes available.

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BRUCE K. MACLAURY
President

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CHAPTER ONE

The U.S. Liability System: Background and Trends

Robert E. Litan, Peter Swire, and Clifford Winston

THE AMERICAN civil litigation system, in recent years, has been placed on trial. Critics charge that the explosive growth in the number of liability lawsuits, coupled with dramatic increases in jury awards and settlements, has caused an insurance crisis—steeply higher premiums for liability insurance and, in some instances, coverage curtailed or withdrawn. For many lines of commercial liability insurance, including products liability and medical malpractice, premiums have skyrocketed in just a few years. For other lines, notably those covering nurse-midwives, municipalities, and day care centers, coverage is simply no longer available in some areas. As a result, the crisis may be dampening productivity growth and pushing up prices for a broad range of goods and services, crippling the international competitiveness of the American economy at a time when it can ill afford it. Only fundamental reform of the nation's civil justice system, critics warn, will make liability insurance more available and affordable.

This outlook is not universally shared. Skeptics acknowledge that property and casualty insurance companies suffered unusually large losses in 1984 and 1985—$1.9 billion and $3.8 billion, respectively—but they attribute these setbacks to excessive rate cutting in earlier years and to falling returns from the industry's portfolio investments. These critics also deny that the civil justice system needs fundamental overhaul. The liability insurance industry, they charge, has launched a "tort reform" campaign to cover its own underwriting mistakes and even perhaps its collusive behavior. The only reform required in their view is more intensive regulation of the industry.

The controversy is not a new one. Public concern over the efficiency and fairness of the civil liability system ebbs and flows with the apparentlycyclical performance of the property and casualty insurance industry. The

previous insurance "crisis," for example, occurred in the mid-1970s, when liability premiums also escalated and coverage was curtailed. The events prompted Congress and state legislatures to examine possible reforms to the nation's tort laws. But relatively little change at either the federal or state levels resulted.

More has happened during the current crisis. Although Congress has thus far failed to agree on any reforms to the civil justice system, most states have recently modified their liability laws—imposing caps on awards and adjusting tort doctrines so that they do not unduly favor plaintiffs—in an attempt to reduce liability costs. In the meantime, however, many customers have abandoned their insurers and chosen to form insurance syndicates of their own or even to self-insure. This has led to a vicious cycle. Because the customers who drop their insurance tend to be low-cost risks, insurers are left with servicing higher-risk customers. This "adverse selection" process forces premiums up still further and in turn induces still more low-risk customers to seek alternative ways of meeting their liability costs.

Nevertheless, calls for reforming the system of civil justice are less urgent now then they have been in recent months. As in previous insurance cycles, increases in premiums have moderated. In some instances, coverage that was withdrawn has reappeared. In 1986 the property and casualty industry earned 11.6 percent on its equity, a return lower than the manufacturing sector average of 13 percent during the past decade but still considerably better than the disappointing performance of the previous two years.

The issues raised by the most recent crisis, however, will not disappear. If nothing else, the dramatic increases in premiums and curtailments of coverage have called greater attention to the nation's civil justice system—whether it is working satisfactorily, and if not why—than at any point in recent memory. Moreover, interest in these issues will intensify if and when the underwriting cycle reverses course and turns against the industry once again.

It is essential therefore that there be a framework within which to evaluate and develop policies that merit consideration. This book attempts to supply that framework by bringing together analyses of the major issues raised by the recent crisis. It also examines certain underlying causes of the recent dramatic changes in insurance markets, assesses the merits of conflicting opinions, and identifies critical gaps in knowledge that must be filled before fundamental disputes can be resolved and sound public policy developed.

The Changing Function of Tort Law

Injuries pose three different and potentially conflicting challenges for all societies. One is efficiently to *deter* behavior that causes injuries. A second and related objective is to exact *retribution* against those responsible. Most societies use some combination of criminal and civil penalties—jail sentences and fines—to meet these goals. The third challenge is to *compensate* victims for their injuries. Compensation may be supplied by the government or by the private sector (through insurance), and may or may not be linked to specific injuries or types of accidents. *Tort law*—rules allowing accident victims to seek compensation through the judicial system from the parties responsible—can be considered a mechanism for meeting all three of these challenges.

Tort rules will efficiently deter accident-causing behavior if responsibility for the costs of injuries is imposed on those who can avoid or prevent accidents most cheaply. If they are well designed, liability rules encourage "cheapest-cost avoiders" to take efficient precautions, unless it is less expensive simply to pay for the cost of injuries. For example, suppose that the plaintiff in a lawsuit could have avoided a $10,000 injury only by taking precautionary measures costing $1,000 but that the defendant manufacturer could have avoided the accident by spending just $100. Holding the defendant—the cheapest-cost avoider—responsible for the costs of the injury would encourage others similarly situated to take efficient precautions to prevent future such accidents.

Of course, tort law administered in this fashion imposes higher costs on those whose activities entail the risk of injury—say, manufacturers of hazardous substances—which requires them to charge higher prices on their products or services to cover the costs of preventing future accidents. Some producers or organizations might even decide not to offer certain products or services because of the liability risks. But if producers and other participants in the economy are not charged for the costs they impose on others through accidents and injuries, resources will be misallocated toward activities that create or perpetuate risks.

Tort law also provides a means for compensating injured parties or *spreading losses* by making individuals or firms with greater resources, either on their own or through their liability insurance policies, pay for the costs of injuries. Misfortune can strike suddenly and unpredictably. A car accident can paralyze and forever change the life of an injured driver or passenger. A drug once thought to be totally safe can later be discovered to cause cancer among many who use it. All societies must choose how

these and similar losses should be borne, either solely by victims or spread in some way among other parties.

One method for spreading losses is to have government-administered (and taxpayer-financed) programs for compensating injured parties, as is the case in New Zealand and Sweden and to a limited extent in the United States through the disability component of the social security system. Compensation through the tort system is an alternative means. In practice, tort law administers compensation through private third-party insurance, which individuals and firms purchase to cover the costs they might owe to injured victims. Liability insurance spreads losses not only among all policyholders but, in the case of business purchasers, among consumers, in the form of higher prices of products or services, and workers, in the form of lower wages. If premiums are based on experience or risk, liability insurance can also deter activities that create risks.

A third objective of the tort system is to exact retribution against wrongdoers regardless of cost. The idea here, of course, is that justice requires wrongdoers to pay a price for their harmful behavior. Criminal laws are designed to accomplish this by punishing those who intentionally inflict harm on others. Many legal scholars argue that the common-law tort system, which requires negligent parties to compensate those they injure, should also be used to assign culpability. Given its focus on the economic functions of the civil liability system, however, this book concentrates primarily on the objectives of deterrence and spreading loss.

As it turns out, these two objectives can conflict. If individuals may recover only those losses that defendants could more cheaply avoid, then the loss-spreading function of the civil liability system will be limited. In particular, injured parties who could have avoided their accidents more cheaply than potential defendants may receive no compensation at all, even in cases where the defendants may have been able to take practical preventive measures. Conversely, if the system is to be used liberally to spread losses, many individuals and firms will be forced to bear costs they may have no way of preventing. Thus, for example, losses may be easily spread by requiring manufacturers to pay for injuries that scientists may some day link to their products. But if the manufacturers have no way at the time to prevent the injuries, then requiring them to shoulder the cost many years later will do nothing to promote deterrence.

The discussions in this book broadly suggest that, in fact, changes in tort law and the growth of third-party insurance during the past two decades have sharply increased the use of the tort system to spread losses, but at the cost of reducing the system's ability to deter harmful activities

efficiently. It was not always this way: a variety of tort doctrines formerly limited the ability of plaintiffs to recover. From the mid-nineteenth century until very recently, for example, plaintiffs could win a tort action only by proving that their injuries were "proximately caused" by the defendant's negligence or by behavior that a "reasonable man" would not have displayed. And plaintiffs could only recover for purely economic damages or medical costs and lost income; they could not be compensated for pain and suffering or emotional distress. At one time, plaintiffs injured by defective products could recover only from the retailers from whom they purchased the products (in legal terms, those with whom they were "in privity"), not from manufacturers. Even when defendants were negligent, plaintiffs could not recover at all if through their own negligent conduct they contributed to their predicament. And some potential defendants, notably federal, state, and local governments, were immune from suit.

Americans have gradually grown more receptive, however, to using the tort system as a vehicle for compensation. Having enjoyed significant advances in living standards, many Americans could afford to pay more attention to the environmental, health, and safety effects of industrial growth. In the 1960s and 1970s Congress responded by authorizing major programs to regulate exposure to harmful substances in the workplace, in products sold to consumers, and in the general environment.[1] During the same years, judges and juries eased the availability and raised the levels of compensation provided through the tort system. Finally, individuals have increasingly sought compensation from the courts because existing insurance policies or government compensation funds have offered less generous compensation prospects.

The increasing importance of the loss-spreading objective of the tort system has been manifested in three ways. Changes in tort doctrines have made it easier for plaintiffs to recover in any given litigation. Successful plaintiffs in certain classes of tort cases have enjoyed larger damage awards and settlements. And the combination of both trends appears to have induced many more individuals to file lawsuits.

Liberalization of Tort Doctrines

Tort law in the United States is largely based not on statutes but on common law, a body of legal principles developed case by case by judges, primarily those in state courts. It is difficult therefore to generalize about

1. See Robert E. Litan and William D. Nordhaus, *Reforming Federal Regulation* (Yale University Press, 1983), pp. 34–58.

the status of tort law in all jurisdictions. Nevertheless, certain important changes in doctrines have occurred in the past several decades, all of which have expanded the system's function in spreading losses:

—Whether by applying the negligence test in a flexible fashion or by imposing liability on parties whose behavior is causally related to accidents but who are not necessarily negligent (so-called strict liability), the courts have increased manufacturers' liability for defective products. Early in the twentieth century courts began to weaken the privity doctrine by allowing plaintiffs and then members of their families to recover directly from manufacturers for injuries caused by defective products. More recently, certain courts have held that a product can be defective even if it conforms to prevailing regulatory standards and if the manufacturer had no knowledge at the time of design or production that it would entail the risks later attributed to it in litigation.

—The negligence standard itself has been extended through litigation to impose liability on a wide class of service providers not previously accustomed to being sued. Day care centers, ski lift, ice rink, and amusement park operators, taverns and restaurants, and not-for-profit organizations have all been taken to court for failures to warn of certain dangers and for the careless conduct of their employees. The exposure of these defendants to liability claims has been widened by the doctrine of joint and several liability, which allows prevailing plaintiffs to recover up to the full amount of a total damage award from any single defendant if the other defendants are unable to pay, and by the collateral source rule, which prohibits juries from reducing damages by subtracting insurance monies or other compensation plaintiffs receive from other sources.

—The concept of contributory negligence has been relaxed in many states so that negligent plaintiffs are no longer totally barred from recovery. Instead, they find their damages reduced by the proportion by which their negligence contributed to their injury. In addition, beginning with the Federal Tort Claims Act of 1946, which waived the federal government's sovereign immunity, courts have made state and local governments liable for tort suits.

—Courts have relaxed the standards plaintiffs must satisfy in proving, under either the negligence or strict liability doctrine, that defendants have caused their injuries. This trend has been manifested primarily in product liability and so-called toxic tort cases, which have frequently required courts to decide whether plaintiffs' injuries have been caused by their exposure, often over long periods of their lives, to substances recently discovered to be associated with the development of cancer or other seri-

ous diseases. Courts have adopted a range of rules to determine causation in such cases. Some have placed liability on the first or last source to which plaintiffs can establish they were exposed; others have made *all* manufacturers of the substance jointly and severally liable. In one noted case involving the exposure of Vietnam veterans to the chemical Agent Orange, a federal court actively encouraged a $180 million settlement even though no hard scientific evidence had been uncovered that linked the chemical to the medical infirmities claimed by the plaintiffs.

—Finally, courts in certain jurisdictions have liberally interpreted statutes of limitation, which bar plaintiffs from recovering if they wait too long after suffering injury (typically more than three or four years) to file suit. In many toxic tort, product liability, and medical malpractice cases, it is difficult to determine when injury actually occurs. It could occur with the first exposure to a substance or operation, or it could develop decades later when the symptoms of disease become observable. Although jurisdictions differ widely on this issue, the trend has been for courts not to invoke the statute of limitations to bar suits involving long-latent injuries.

Higher Damage Awards and Settlements

The tort system allows for compensation to injured parties through lawsuits and, far more importantly, through claims resolution by liability insurance companies. Indeed, of the millions of insurance claims filed each year, typically only 2 percent are resolved through litigation. Of cases brought to court, less than 5 percent are tried to verdict; the rest are settled.[2]

In addition, the amounts actually received by successful plaintiffs are often much smaller than those originally awarded by juries. Trial judges and appellate courts may, for instance, override jury verdicts; or in some cases the defendant may not have sufficient resources (even with insurance) to satisfy the judgment. One recent study of 198 tort verdicts in 1984 and 1985 that resulted in awards of $1 million or more found that the successful plaintiffs received the original jury award in only 51 cases; the final distributions to plaintiffs in the other cases were, on average, 30 percent less than the amount originally awarded.[3]

In short, jury awards represent only the tip of the tort system and

2. William E. Bailey, "The High Cost of Insurance: Who's to Blame?" *The Brief,* vol. 16 (Winter 1987), pp. 15–18.

3. Ivy E. Broder, "Characteristics of Million Dollar Awards: Jury Verdicts and Final Disbursements," *Justice System Journal,* vol. 11 (Winter 1986), p. 353.