Chapter 7
Topics in the Economics of Tort Liability

I. Extending the Economic Model
   A. Relaxing the core assumptions of the model developed in the previous chapter
      1. Decision makers are rational
         • In order to respond rationally to the signals conveyed by tort liability, individuals must be able to, among other things, make reasonable calculations regarding the expected costs of accidents.
         • To the extent that individuals underestimate or overestimate the probability of an accident or the cost of the accident, calculations will be incorrect and the individual will not take the cost-minimizing level of precaution. Consider, however, 1) the implications of random errors by injurers and victims and 2) the fact that errors tend to be “at the margin”
      2. There are no regulations to reduce external costs
         • Regulations act to prevent accidents from occurring. Liability acts to distribute costs after an accident occurs. Consider, for example, regulations that govern the behavior of drivers and boaters.
         • When regulators have better (lower cost) access to information and are not subject to undue influences, regulations can minimize the costs of accidents at lower costs. Thus, courts should use regulations as guidelines in determining liability. This helps lower the transaction costs of determining liability.
         • When regulators are subject to corruption (or capture by an industry) courts are in a better position to establish incentives for efficient behavior (and shouldn’t necessarily take regulations into consideration).
      3. There is no insurance
         • Both victims and injurers can insure themselves against the costs of accidents: which is better?
         • Insurance by victims (which occurs under a rule of no liability) might diminish the incentive injurers have to take precaution (because insurance payments substitute for damages paid by the injurer) and create a “moral hazard” by reducing the incentives for victims to take precaution (because they know they will be compensated for an accident by the insurance company). However, subrogation clauses (which allow insurers to sue injurers), deductibles, and co-insurance (which impose costs on the insured party) reduce the likelihood of these behaviors.
         • Insurance by injurers (which occurs under a strict liability rule) can also reduce the incentive for injurers to take adequate precaution. However, deductibles, co-insurance, and experience ratings all reduce the likelihood of these behaviors.
         • A bigger question that must be addressed concerns the overall stability of the insurance industry. Consider the insurance “crisis” in the mid-1980s and the current “crisis” in medical malpractice insurance.
4. Bankruptcy
   - *Limited liability* enables an injurer to externalize part of the risk it faces from liability for accidents if the actual payout is less than the amount of damages.
     - Strategies to limit liability include subsidiaries, secured corporate debt, and securitization of future income.
     - Possible solutions to address this problem include replacing strict liability with negligence and replacing tort liability with regulations.
     - This problem is very difficult to solve.
     - Consider the implications for caps on damage awards (currently being proposed as part of the solution for the medical malpractice “crisis”).

5. Litigation costs (incurred by the victims and injurers) are zero
   - As the cost of litigation increases, victims will bring fewer suits; compare litigation costs to the expected value of a claim against an injurer. This may lead potential injurers to take less precaution because the *effective* expected cost of an accident decreases with a decrease in the number of claims.
   - In contrast, high litigation costs may induce injurers to take more precaution to reduce the expected costs of litigation.
   - The net effect of litigation costs is unclear.

6. Conclusions regarding the core assumptions
   - No strong reason to seriously doubt the basic conclusions of the model developed in chapter 8.

B. Extending the Basic Model
   1. Vicarious liability
      - One person (employer, parent) might be held liable for the torts committed by another (employee, dependent child)

      - *Respondeat superior* and *strict vicarious liability* versus *negligent vicarious liability*.
        - The former is based on the assumption that the employer is better able to take precautions that avoid accidents caused by employees.
        - In contrast, the latter creates more of an incentive for employers to reveal information regarding torts to authorities than does the former and may thus be preferred on efficiency grounds

      - Dram shop laws
2. Joint and several liability with and without contribution

- When two or more parties can be sued for causing the same accident, they are said to be jointly liable. They are severally liable when they can be sued in separate trials. Without a provision for contribution, the victim could receive multiple damages.

- In general, a rule of joint and several liability is applicable when 1) the injurers acted together to cause the victim’s harm, or 2) the victim’s harm is indivisible. Note that this rule reduces the high costs that could be incurred by victims in the process of trying to prove who caused the harm and increases the probability the victim will receive full compensation for the harm caused.

- The rule of joint and several liability has been modified by the provision for contribution, which allows one injurer to sue other injurers for part of the costs of liability. However, because the potential for contribution enables potential injurers to externalize part of the costs of liability, a rule of no contribution is more efficient than a rule of contribution with respect to precaution by injurers, but it creates the problem of eager victims.

3. Evidentiary uncertainty and comparative negligence

- For a long time, negligence with a defense of contributory negligence was the preferred negligence rule. However, in the past 25 years, comparative negligence has come to be the dominant rule for non-product-related torts. This change has been motivated primarily by equity considerations. The relevant question from our perspective is: is one rule preferred to the other on efficiency grounds?

- In the preceding chapter we showed that, assuming complete information and no errors by the courts, the answer to the preceding question is no. However, the answer could change if the court makes random errors, i.e., if there is evidentiary uncertainty.

- Recall that, in the case in which a court makes a random error with respect to the appropriate level of precaution, injurers will tend to take a level of precaution that exceeds the efficient level. While this is true regardless of the negligence rule in effect, the amount of excess care will be greater under a rule of negligence with a defense of contributory negligence than it would be under a rule of comparative negligence. This is because, under the latter, the two parties will share the costs of the court’s mistake, while under the former, all of the costs will fall on one of the two parties.

- The preceding observation is countered by the observation that, because of the difficulties encountered when attempting to apportion blame between the two parties, the administrative costs of comparative negligence are likely to be higher than those associated with negligence with a defense of contributory negligence.

- There is no way for us to conclude, at this point, which rule is more efficient.
II. Computing Damages
A. Hand Rule damages
   1. Two concepts of compensatory damages
      - indifference
      - risk equivalence
   2. *Compensatory damages* are perfect when the damage award leaves the victim indifferent between injury and compensation on the one hand and no injury on the other. This approach to setting damages when market prices can be observed.
   3. For losses for which there is no observable market price and, more importantly, no price at which the victim would receive injury, we must employ an alternative means of computing damages. The *risk-equivalent method of computing damages* focuses on the willingness to pay for an incremental reduction in the risk of harm and uses this to estimate the value of, among other things, the loss of a life or significant physical harm. There are, however, significant problems with this approach, including the use of linear extrapolation and willingness to pay for voluntarily versus involuntarily assumed risks.

B. Punitive damages
   1. We need to consider two questions:
      i. Under what conditions are punitive damages awarded?
      ii. How should the amount of punitive damages be computed?
   2. The answer to the first question is generally answered, in vague terms, by statute, e.g., when the defendant’s behavior is malicious, oppressive, gross, willful and wanton, or fraudulent, i.e., socially unacceptable.
   3. The answer to the second question depends on the purpose the punitive damages are intended to serve. We focus on the situation in which the tort-liability system works imperfectly, i.e., fails to hold injurers accountable when they are at fault. Note that this could lead potential injurers to take advantage of the system and behave in a sub-optimal fashion. In this case, punitive damages can be used to provide the correct signals to potential tortfeasors regarding the efficient level of precaution.
      a. To the extent that the system is imperfect, the actually cost of accidents incurred by injurers decreases, and this leads them to take less than the efficient level of precaution (because the marginal benefits of precaution have declined).
      b. To offset this decrease in compensatory damages paid, impose punitive damages which cause the total damages paid to increase until the expected value of damages equals the true expected cost of the accident.
      c. *Example*: Assume that, for a particular class of accidents, when an accident occurs, the harm ($A$) is $500 and the probability of the accident is 0.1. As such, $p(x)A = $50.
However, assume the injurer only has to pay in 25 percent of the situations in which an accident (and harm) occurs. In this case, his/her expected cost is 0.1($500)x0.25 = $12.50. (Note that the 25 percent is called the “enforcement error.”) Thus, the expected liability for an accident is lower than the true expected cost of the accident. This in turn leads to a reduction in the perceived marginal benefits of precaution and a reduction in the amount of precaution taken.

To compensate for the effects of the enforcement error, adjust damages upward by the “punitive multiple (m),” which is the inverse of the enforcement error; in our example the punitive multiple equals 4. As such, damages would equal $2000; $500 in compensatory damages and $1500 in punitive damages. More importantly, the expected value of damages is now $50 = 0.1(2000)x0.25, which is the true expected cost of the accident.

The end result is that injurers now have an incentive to take the efficient level of precaution.

III. An Empirical Assessment of the U.S. Tort Liability System

A. Some General Facts About the American Tort-Liability System: Descriptive data

1. In 1994, approximately 41,000 tort cases were resolved in federal district courts.

2. In 1994, approximately 378,000 tort cases were resolved by state courts in the 75 largest counties in the United States.
   - 60 percent of these cases dealt with automobile accidents
   - 17 percent were cases involving “premises liability” (slips and falls, etc.)
   - 5 percent involved medical malpractice
   - 3.4 percent involved products liability

3. 94 percent of the cases referred to above involved an individual plaintiff.

4. There were only 353 punitive awards between 1965 and 1990 in all product liability cases. After appeal, those awards averaged $135,000

5. The rate of many types of accidents has been declining.

These statistics stand in stark contrast to the assertions that the tort liability system is out of control.

B. Medical Malpractice: Skip this section

C. Products Liability

Changes in products liability law have caused many insurers to withdraw coverage for certain products and some manufacturers to quit making certain products.

1. The efficient liability standard for products-related accidents
   a. The liability standard in product-related accidents is called “strict products liability.” To be held liable under the “strict products liability” standard: a product must suffer from at least one of the following three defects:
      - a defect in design
• a defect in manufacture

• a defect in warning.

b. What is the efficient standard?
Clearly, in most cases, bilateral precaution is possible. Thus, strict liability with what amounts to a defense of contributory negligence is the economically efficient standard. In this case, we describe contributory negligence as the victim voluntarily assuming certain risks and misuse. Assume, for example, that a victim slips and falls while cutting the grass, severely cutting his foot in the lawnmower in the process. Assuming the manufacturer installed all of the standard safety precautions, manufactured the mower properly, and included warnings about when use of the mower might be more likely to lead to an accident, the victim could not recover damages from the mower manufacturer. The victim voluntarily assumed the risk of this accident.

2. Reforming products liability
   a. Manufacturers’ demands for a uniform federal products-liability law.
      Two reasons
      i. Standardization of the law among the states would reduce administrative costs, leading to savings for consumers.

      ii. Products liability law, as it is currently structured, is biased against manufacturers.

   b. General observations
      • Excluding asbestos claims, the number of products liability cases in federal courts fell by 40 percent between 1985 and 1991.
      • In addition, between 1981 and 1987, defendants won 51 percent of all cases. Between 1988 and 1994, defendants won 64 percent of all cases.

D. Mass torts: *Skip this section*