

Law and Economics
Session 15
Tort Law 2

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- Today we extend the basic model of tort liability:
 - Regulation
 - Insurance
 - Judgment-Proofing
 - Joint and Several Liability
 - Vicarious Liability
 - Punitive Damages

- Often potential injurers are subject to both the risk of liability and “safety regulation.”
 - Example: fire extinguishers.
- Issue: Why both? Why not use just one of them?

- The advantages of regulation:
 - Ex ante enforcement (i.e., regardless of the occurrence of harm).
 - This difference matters when the injurer has limited liability exposure (“judgment proofness” problem) or when the victims are not organized
 - Regulatory agencies may have special expertise relative to courts (e.g., EPA in environment issues.)

- The Advantages of “tort liability”
 - Regulatory agents may be political appointees and may be susceptible to industry “captures.”
 - Regulatory agents may be career-motivated and over-regulate.

- Potential victims may buy insurance against accidents.
- Effects of such insurance
 - Victims may not sue, which may weaken the deterrence effect.
 - Victims may not take enough care (“moral hazard”).
- Similarly, potential injurers may buy liability insurance, which also weakens deterrence.

- Victim's insurance company can go after injurer (or injurer's insurance company)
 - This is called "subrogation"
- Moral hazard can be mitigated by deductibles, experience ratings, safety standards.

- Injurer can declare bankruptcy to avoid paying compensation.
- Limited assets limit liability exposure of the defendant.
 - A defendant cannot pay more than he has.
 - Injurer pays less than compensatory damages
 - Weakens the deterrent effect of tort law.

- A can cause harm to B in the amount of \$1 million. If A invests, which costs him \$300,000, then he can prevent the harm; otherwise, the harm occurs with probability 0.5. Suppose that A's assets, when liquidated at the time of lawsuit, are worth \$500,000.
- Without limited liability, A invests.
- With limited liability (assets of \$500,000) A will not invest, which is inefficient.

- Financial and corporate strategies adopted to create “judgment proofness”, i.e., to shield assets from tort claimants.
- For example:
 - There was a 41% rise in taxi and livery accidents in New York City between 1990 and 1998.
 - Many of the victims were unable to collect the their awards after receiving favorable judgments at trial.

Why couldn't they recover?

- Taxis held minimal liability insurance and the taxi medallions, worth \$275,000 each, were unreachable by the victims.
- In particular, taxi medallion owners used the medallions as collateral for loans.
 - “Even when the rare victim tries to seize a medallion in court, it is common to find that the owner has attached so much debt to it that there is little money left to recover.”
- Owners of large cab fleets divide into smaller legal entities with just two or three cabs each.
 - If one driver harms a passenger, the passenger will only be able to recover from this smaller group.
- Not limited to taxi industry: Physicians, lawyers, accountants, board members, oil companies.

- Secured Debt
 - Tort victims are below secured debt in bankruptcy proceedings (e.g. taxi medallions).
- Asset Segregation
 - That is, separating different activities of the same organization under different legal entities.
- Asset Securitization
 - If a company securitizes cash flows (that is, future profits have to go to bond holders), tort victims can't recover out of those flows.

Joint and several liability

- What if there are multiple injurers?
 - This is especially common in medical malpractice lawsuits, where the codefendants are the doctor and the hospital.
 - Say D and H are injurers (Doctor and Hospital), causing a loss of \$100 to V (Victim). Who can the victim sue? And how should the injurers split damages?
- “Several liability” (proportional liability): V can sue D and/or H separately, but only for their portion of the liability.
 - e.g., if the doctor is 80% responsible and the nurse is 20% responsible, V can recover \$80 from the doctor.
- “Joint and several liability”:
 - V can sue D or H individually or both D and H simultaneously. He can recover the full \$100 from either D or H, even if they are only partly responsible.
 - V’s incentive is to go after “the deep pocket” – in this case, probably the hospital

- Pros:
 - Difficult and costly to disentangle the responsibility:
Defendants can sort out this issue better than the plaintiff.
 - Prevents under-compensation in the presence of limited assets.
- Cons:
 - Unfair allocation of damages burden (e.g., a defendant with deep pocket may be targeted even with a small liability).
 - Encourages lawsuits.

- Most states with JSL have a “contribution rule”:
 - The defendant paying for the full damages is allowed to sue the remaining defendants for their contributions. Courts deduct contribution of one party from the compensation owed by the other.
 - This prevents double recovery: If V settles with D for \$40, he can get at most \$60 from H. .

Contribution vs. No contribution

- Under a contribution rule, defendants may have inefficiently low precaution incentives because they will be responsible for only a piece of the harm if it occurs.
- On the other hand, under a no contribution rule (where plaintiff could recover 100% of damages from all co-defendants), there would be much more tort litigation, especially against people who were only marginally related to a harm.

- Some states have a “collateral source rule,” which means that if you are compensated for injuries by casualty insurance, you can still recover from the injurer.
- Some states have repealed this rule, meaning that if you are compensated by an insurer, you can't sue for that amount.
 - This reduces litigation, but also reduces precaution incentives.

- Sometimes, an individual different from the injurer is “vicariously liable” for tort damages:
- Generally, a “principal” can be liable for the tort harms of his “agent.”
- Examples:
 - Parents are liable for children
 - Employers are liable for employee (e.g., the McDonald case)

- Individual rationality
 - Children
 - “Dram shop” laws
- Relaxing judgment proofness
- Providing monitoring incentives (in selecting employees, providing the right types of tools and instructions).

Vicarious Liability and Independent Contractors

- Vicarious liability by employers for the torts of employees is one of the big factors underlying the trend toward using independent contracting rather than employment.
- For example, truck drivers are usually independent contractors for Wal-Mart, rather than Wal-Mart employees.
- The truck drivers will probably be judgment-proof, so truck accidents are probably insufficiently deterred.

Punitive Damages

- Damages in excess of compensation of harm.
- Usually meant to punish the defendant for reckless/intentional conduct (“oppressive, gross, willful, egregious, wanton, fraudulent. . . .”)
- No exact criteria on when they should apply and no exact formula for their amounts.
- More than half the states prohibit or cap punitive damages or require a higher evidence standard

- Insufficient assignment of liability
- “Enforcement errors”
- Recall our bilateral precaution example:
 - Suppose $D = A$.
 - If there is no error, Defendant faces $x + p(x)A$, so Defendant chooses $x = x^*$.
- Suppose that Plaintiff sues only with probability $e < 1$ (or defendant found liable only with probability $e < 1$)”
 - Defendant faces $x + p(x)eD$
 - $D = A$ will not be enough; increasing to $D = A/e$ will create the correct incentive.

- In the mid 1990s tort cases became the most common type of case
- In 1994:
 - 41,000 tort cases resolved in federal district court
 - 378,000 resolved in state courts (75 largest counties)
- Types of tort cases:
 - 60 percent of cases involve automobile accidents.
 - Next most common (12 percent) is slips and falls.
 - Third most common (5 percent) is medical malpractice.

- The costs of accidental injury from (largely individual) plaintiffs to (largely institutional) defendants is justified by two arguments
 - (1) institutional defendants are generally more able to prevent accidents
 - (2) it is good policy to provide insurance through the tort system for the costs of those accidents that can not be prevented
- Not too much empirical evidence on these arguments, though.

- Critics say that there are too many lawsuits and too frequent awarding of large punitive damages.
- Facts do not necessarily agree:
 - Punitive damages are very rare (less than 1 percent of cases)\
 - Appellate courts reduce punitive awards
 - Many states limit or prohibit punitive damages and impose higher evidentiary standard.

Litigation Costs of Auto Accidents

- The costs of litigation and settlement account for an estimated 33 percent of the costs associated with automobile accidents.
- But no-fault policies increase the number of accidents by 5-10 percent.

- The third most common type of tort case
- Some relevant estimates:
 - 1 percent of care is negligent
 - Only 10 percent of injured patients file a lawsuit.
 - At most 5 percent of health care costs are due to defensive medicine.
- Indiana capped malpractice awards at \$500,00:
 - Malpractice awards increased!

- Motor vehicle related accidents and injuries have declined.
- The number of product liability cases is dropping and defendants are more increasingly winning.
- Similar story in medical malpractice cases.
- Problem may not be that there are too many rather that there are too few lawsuits.

Empirical effects of tort rules on accidental deaths

- Rubin and Shepherd (JLE 2007) find that repealing the collateral source rule increases accidental deaths.
 - This is as predicted from the reduced precaution incentives
- However, they also find that noneconomic damage caps, a higher evidence standard for punitive damages, product liability reform, and prejudgment interest reform are associated with **fewer** accidental deaths.
 - This is against the incentive theory, suggesting that before these reforms tort incentives were too strong.
- Carvell et al (RAND 2012) find that JSL Reform also reduces deaths, suggesting that without a “deep-pockets rule,” the “shallow-pocket” defendant takes more precaution.