

Promoting Economic Efficiency in American Tort Law

Jordan A. Dresnick & Randi J. Spector

Abstract

Tort damages cost Americans one quarter of a billion dollars annually. The price of a given good is comprised in part of a “tort premium” to cover the expected cost of litigation and damage awards on the item. Some states have records of awarding higher tort compensations. We argue that the “tort premium” should reflect the expected litigation costs in the particular state where the item is sold to promote efficiency and consumer welfare. By similar logic, the price of hurricane insurance is greater in Florida than in Connecticut due to the greater expected costs of hurricanes in the former.

An Introduction

Tort law concerns civil lawsuits that result outside of contractual obligations and include accidents and intentional acts, like the faulty design of an automobile. Tortious acts injure millions of Americans (Shukaitis 1987) and generate costs in the United States of over \$245.7 billion each year. One of the law’s most fundamental questions today concerns the role of products liability in relation to alternative compensation schemes for accidental losses (Werro 2001). Our work explores the economics underlying the American tort system. Currently, a portion of all revenues received on goods sold throughout the country funds the expected cost of litigation and damages resulting from torts; we refer to this revenue as a “tort premium.” Inefficiencies result today as resources are misallocated because “tort premiums” often act as subsidies and fail to accurately reflect the true scarcity value of the underlying factors.

Most economists regard price as the driving force in the marketplace. Price is the assigned monetary value of a good, asset, or service. It is also the exchange ratio between goods, thus

reflecting a utility preference by buyers. Under the assumption that more is better, it follows that consumers receive greater utility at correspondingly lower prices. This article demonstrates that the prices of thousands of products that we consume everyday do not accurately reflect the expected cost of litigation and damages associated with that particular good.

Tort Through the Eyes of Lawyer and Economist

While most legal scholars regard law as a set of obligations cemented by sanctions, economists see the law largely as a series of prices (Cooter 1984). Economists consider that products with relatively high prices generate greater utility than those at correspondingly lower prices. For example, a consumer willing and able to purchase an automobile for \$20,000 would only pay \$21,000 for that same vehicle if the additional \$1,000 expenditure were equal or greater than the consumer's corresponding increase in marginal utility. As another example, consider the market for hurricane insurance. Miami Beach, Florida is hit, on average, with a hurricane every 4.5 years, while Jacksonville, Florida is only struck, on average, once every 15 years (Sun Sentinal 2005). Assuming that the damage rendered on a particular home in Miami is identical to that of Jacksonville, it follows that hurricane insurance would cost more in Miami relative to Jacksonville.

Just as the price for hurricane insurance varies between geographic areas according to the expected hurricane damage, "tort premiums" for goods and services should reflect the expected cost of a tort suit in the jurisdiction where the good or service is sold. If there were a market for insurance to cover such litigation and damage awards, the rates charged for the insurance would be higher in those legal jurisdictions with a relatively easier barrier to suit and recovery of damages. Classical microeconomic theory predicates that in such a market, consumers will

demand a quantity less than at the rate if the price were to accurately reflect the scarcity for the resources in question.

The Economics of Tort Reform

Tort reform has been among the nation's leading political issues since the mid 1990's (Note 1996). This debate has only intensified by virtue of a series of recent, large frivolous lawsuits, such as a \$4 million verdict against BMW for a bad paint job, a \$2.9 million dollar verdict against McDonald's over spilled coffee, and a multi-plaintiff verdict for \$3.4 billion against CSX even where no one was seriously hurt. Notwithstanding the public outcry against frivolous lawsuits, courts across the country have embraced the upsurge in tort cases by eroding the theory of negligence that had enabled defendants to argue that the injured victim had "assumed the risk." (Keatron 1973). The New Jersey Supreme Court contributed to this trend by finding a manufacturer liable for failure to warn even though the manufacturer would not have known of the risks at the time the product was manufactured (Larsen 1984). This change in law has led to an increase in legal defense costs resulting from greater litigation brought with larger damages, to more plaintiffs. The additional defense costs and damage awards have been passed on to consumers in the form of higher prices.

Although economists and attorneys have developed models to discuss the "tort premium" and often suggest rejuvenating tort law, courts across the nation have issued mandates in clear language that they alone are capable of bringing change to the system (Sugarman 1985). We concur and argue that the price paid for a particular good should match the utility received from that product. The "tort premium" paid on an item is essentially an insurance premium to cover the expected cost that a manufacturer faces in a tort claim for that product. It follows that the

“tort premium” should be relatively less in a jurisdiction where plaintiffs face a higher burden to successfully bring suit vis-à-vis jurisdictions with comparatively easier burdens.

Microeconomic theory teaches that consumers purchase smaller quantities of a particular good at relatively higher prices. Manufacturers should therefore charge lower prices in “more difficult to sue” jurisdictions because the expected cost of a tort claim is relatively low, compared to that of an “easy to sue” jurisdiction. Consider, for example, the insurance premium paid on automobiles. The “tort premium” for a vehicle covers litigation costs and expected damages for “crashworthiness,” defined as “the protection that a passenger motor vehicle affords its passengers against personal injury or death as a result of a motor vehicle accident” (Note 1967).

As a case study, we turn to West Virginia, and the state’s Supreme Court opinion in *Blankenship v. General Motors Corp.* (“Blankenship”). West Virginia’s basis for strict liability was first developed in 1902, in *Peters v. Johnson, Jackson & Co.* Strict liability, rather than ordinary negligence, is automatic responsibility, liability that does not depend on actual negligence or intent to harm, but is instead based on failing to make an item safe (Garner 2004). Just nine years later, the state adopted the *Rylands v. Fletcher* Doctrine, which held a manufacturer liable for the damages caused by a dangerous product if the product intrinsically produces a dangerous condition, even in the absence of any negligence. In 1939, West Virginia moved to incorporate the Doctrine of *Res Ipsa Loquitur* into negligence actions in *Webb v. Brown & Williamson Tobacco Co.*, which meant that plaintiffs need only prove that the injury would not ordinarily result in the absence of someone's negligence and the item in issue was under the defendant's control.

The West Virginia Supreme Court continued evolving tort law in *Morningstar v. Black & Decker Mfg. Co.* There, the plaintiffs filed a personal injury action against Black and Decker for the manufacturer of an “8-Inch Builders Sawcat.” One of the plaintiffs was injured when the saw's safety guard failed to close and his spouse brought suit for loss of consortium. The court held that West Virginia's common law was flexible and the standard of reasonable safety should not be determined by the manufacturer in question, but rather by what a reasonably prudent manufacturer's standards should have been at the time the product was made.

By the mid-1980s, every state in the nation recognized crashworthiness except Mississippi and West Virginia (Levenstram 1989). In 1985, Mississippi adopted strict liability for crashworthy cases (Toliver 1985). The Mississippi Supreme Court based its decision on a rationale to shift the cost of injuries from the public to the manufacturer and to ease the plaintiff's otherwise difficult burden.

West Virginia followed suit in *Blankenship*. There, a passenger sustained injuries while traveling in a manufacturer's car. The plaintiff alleged that her injuries were enhanced by a design defect in the vehicle. The issue before the court was whether a lawsuit filed against a seller of a motor vehicle states a cause of action under West Virginia law if the suit merely alleged that the injuries resulted from a collision and were enhanced by a design defect in the vehicle. The court answered in the affirmative, explicitly adopting the crashworthiness doctrine. The court held that in any crashworthiness case where there is a split of authority on any issue, as for example plaintiff's burden of proof, that it would adopt the rule most liberal to plaintiff, making West Virginia an “easy to sue” jurisdiction. In economic terms, this lessened the standard required to bring suit.

Blankenship continues the progressive movement by American courts toward a more liberal filing for plaintiffs. General Motors (“GM”) argued that adopting the plaintiff’s version of the case would invite juries to second-guess the safety standards promulgated by the National Highway Traffic Safety Administration and find designs approved by federal regulators to be defective. The West Virginia Supreme Court rejected GM's position, holding instead that GM, the largest auto producer in the world, collects a product liability premium every time it sells a car anywhere in the world. Although the Court recognized that it was alone is powerless to improve the nation’s tort system, the justices noted “this Court would be both foolish and irresponsible if we held that while West Virginians must pay the premiums, [and held that] West Virginians can't collect the insurance after they're injured” (*Blankenship* at 785).

This argument raises a question of price theory. Assume Ms. Blankenship had purchased the automobile in controversy for \$20,000. According to the West Virginia Supreme Court, the price for the automobile, \$20,000, is composed of an amount for the vehicle and an insurance premium used to cover the cost of litigation *across the country*. Assume the price for the car is \$17,000 and the insurance premium is \$3,000, equaling \$20,000. The court effectively rebuked the argument that West Virginians be forced to pay the litigation premium of \$3,000 for a GM vehicle if the car manufacturer fails to provide an insurance value for the “tort premium” paid. In summary, *Blankenship* teaches that consumers must receive the marginal benefits for the marginal cost paid.

Contrast the “tort premium” paid for a pen with that for an automobile. Although the relative percentages paid for the “tort premium” on both items may be comparable, it is conceptually more simplistic to illustrate the effect on consumer welfare of implementing a \$1,000 tax vis-à-vis a \$0.01 “tort premium” on a pen, for example. In theory, the aggregate

result is the same even though the one percent increase on the "tort premium" of the pen is only one cent, it still has the same effect in diminishing consumer welfare. Thus, the imposition of a "tort premium" will reduce the quantity demanded of both expensive and inexpensive items or lead to economic inefficiency.

II. The Economics of Products Liability

Economic efficiency mandates that consumer welfare is not diminished by ensuring that the price paid for a given good or service accurately reflects the utility received from that purchase. Thus, a consumer should not pay \$20,000 for an automobile when in fact the price includes a \$3,000 "tort premium" if the consumer cannot benefit from the "tort premium" charged in the particular state. This would occur if the consumer lives in a "difficult to sue" jurisdiction and is forced to pay a \$3,000 subsidy to cover expected litigation and damages in "easy to sue" jurisdictions. For example, American consumers receive hundreds of billions of coupons each year in an attempt to make the most out of relatively low-value purchases (Nevo 2002). Thus, it follows naturally that these same consumers should care even more about "tort premiums" in order to save more than mere cents.

The Relationship Between the Consumption Decision and Tort Premiums

Every individual consumer has a finite amount of income to spend and must therefore allocate choices between alternative goods in such a manner that maximizes consumer utility. Consider a market where consumers have a choice of two items: guns and butter. Assume the consumer earns \$100, and each gun and unit of butter costs \$10. The consumer may purchase ten guns and no butter, nine guns and one unit of butter, and so on. Now consider that a premium is imposed on every gun sold so the price of each becomes \$11. All things equal, the consumer will demand fewer guns at this higher price. Prices can increase as supply decreases

and demand remains static. In other words, the price decrease does not reflect a heightened scarcity in the supply of guns, but rather demonstrates the substitution effect of the tort premium.

The substitution effect occurs because a higher price means that an individual has to give up more of other goods for each extra unit of a good whose price has risen. The new trade-off discourages consumption of the relatively high priced good, as the consumer will substitute other products in lieu of the higher priced items. By similar logic, a lower price of a good encourages consumption of that good. Here, the substitution effect results in economic inefficiency because it results in negative producer and consumer surplus. To promote economic efficiency, prices should reflect the scarcity value of resources.

The Implementation of the Tort Premiums

Based on the substitution effect, consumers should only be charged a “tort premium” that reflects the true, expected cost of their tort litigation and damages. By analogy, consumers who live in “easy to sue” jurisdictions are unequivocally part of a market segment that has chosen to pay higher insurance premiums, by means of the “tort premium,” in exchange for greater protection against torts. Those who live in more “difficult to sue” jurisdictions have joined together to express a weariness to frivolous lawsuits and have instead opted to pay lower prices on goods and services.

A premium is efficient if and only if it accurately reflects the benefits that either equal or outweigh its cost on *that* particular good consumed. The imposition of an inefficient “tort premium” will lead to a decrease in the quantity demanded for a particular good or service. Producer and consumer surplus is diminished when consumers in particular markets are charged higher “tort premiums” and where the premium is assessed in a proportion that does not truly reflect the expected cost of litigation and damages. Producers must carefully evaluate the “tort

premium” imposed on goods and services offered for sale so that these insurance premiums are more than mere subsidies.

Numerous scholars have explored a similar phenomenon in the context of pollution. “If strict liability is not imposed for the residual damages caused by partially controlled polluting activity, these damages will not be reflected in the price of commodities, produced by such activity. As a result, commodities that produce pollution will be under-priced relative to commodities whose production causes no pollution, resulting in resource misallocation” (Polinsky 1980). Similarly, there may be a resource misallocation on services and products where the “tort premium” does not accurately reflect the true benefit of the insurance premium included in the “price.” While economists recognize that rational, self-interested manufactures charge equilibrium prices, often generating both accounting and economic profit, such firms should not charge equal “tort premiums” in jurisdictions across the country but instead should charge based on the expected cost of litigation and damages in that state.

Policy Implications

Rational, self-interested producers must take measures to ensure that the price of goods and services reflects all costs, including defense of tort litigation and payment of damage awards. For example, assume that McDonalds currently sells its coffee for \$1.00 per cup and that this price includes a “tort premium” of \$0.01 per cup. Few could have expected the \$2.9 million jury verdict in the case where a woman spilled coffee on herself. As a result, McDonalds’ executives might review the calculus used in determining the “tort premium” on the coffee and instead impose a higher “premium” of \$0.05 per cup. The resulting price for the cup of coffee would therefore be \$1.04. If executives across the country were to evaluate the “tort premiums” charged on goods and services, both for the “easy to sue” standard within the jurisdiction, as well

as following the issuance of frivolous damage claims, prices would more aptly reflect the scarcity value for the underlying factor.

Consumers are aware of the cost of the goods and services purchased. As prices on commodities fluctuate pursuant to frivolous damage awards (*i.e.* those damage awards which no manufacturer or provider of service could reasonably foresee under any circumstances or nightmare), tightening standards to bring suits, and other related legislation, the public can react with their consumption choices. Economists generally agree that the free market is the best form of democracy in that consumers cast ballots each day with the dollars they spend on goods and services. If juries and judges would like to encourage a consumer's negligent spilling of coffee by issuing \$2.9 million verdicts, then the price paid for a cup of coffee should increase to capture the costs associated with defending more lawsuits of this type and the possibility of having to pay damage awards of this enormity. Alternatively, prices on commodities in individual states should fall if juries and courts opt to curtail damage awards in particular states.

Conclusion

The West Virginia Supreme Court first drew attention to the notion of "tort premiums" in *Blankenship*, adapting the state's tort law so that the "tort premium" accurately reflects the scarcity value of the involved factors. Under its current state, the American tort system is little more than a method of subsidies. Recent newspaper headlines have only garnered increased attention. Consumers in "hard to sue" jurisdictions presently pay "tort premiums" equal to those in "easy to sue" jurisdictions, despite receiving starkly divergent benefits. Those in the former therefore consume at less than Pareto's optimal level whereas those in the latter consume at a level that exceeds the optimal point. This results in a situation in which neither consumer surplus nor producer surplus is maximized.

The use of price theory can ameliorate this inefficiency by setting prices in such a way that a price paid on a given good or service is equal to the utility received. At the same time, the “tort premium” may act as a lever of social policy, shifting costs to those consumers who demand relatively high insurance coverage for negligent actions. There is still much to be explored in this intriguing and emerging area of law and economics.

Jordan A. Dresnick practices commercial litigation and antitrust law with Holland & Knight in Miami, FL. Randi J. Spector, a former Lawyer’s for Literacy Fellow, works with Legal-Up, a community-sponsored program operated in conjunction with the Miami-Dade Family Learning Partnership.

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