Fundamental Reform of Tort Law

Paul H. Rubin

The high costs of many goods and services can be traced to misguided attempts by federal regulators and courts to protect the public health and safety. The problems with the courts are especially serious, since they undermine more cost-effective means of achieving that goal.

A principal function of tort law is to deter manufacturers from causing excess harms, or, in the case of medical services, to deter malpractice. But this system has been undermined by unreasonable standards—imposed by the courts—defining parties' liability for damages.

Further, the best alternative means for securing low-cost protection has also been undermined. Before 1960, when parties agreed on an exchange of goods or services, they implicitly, if not explicitly, also agreed on the rules and limitations that would govern any liability for possible injuries. But over the past three and a half decades courts have voided such contracts, reserving for themselves the power to make determinations of liability.

If policymakers wish to lift a burden on the economy as well as provide cost-effective protection for consumers, they must undertake major reforms that restore rational tort law and, most importantly, the rights of contract.

Government intervention in the market is justified only in circumstances where the market can be expected to "fail." The most common source of market failure is the existence of some externality. An externality is said to exist when a third party, one not directly involved in a transaction, is nonetheless affected by the transaction. The classic example of a negative externality is pollution, where bystanders are harmed by the actions of polluters. Some effort at correction—by establishing or redefining property rights, by internalizing the costs of the externality, or, if all else fails, by direct government regulation—is justified by such externalities.

By this standard, much of modern tort law and much of modern government regulation purporting to protect safety and health cannot be justified, since no externalities exist that must be dealt with. Both forms of government intervention—by the courts and by regulatory agencies—stem from the fact that policymakers are unwilling to rely on private transactions to achieve efficient outcomes.

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Undermining Contracts

Much tort law governs accidents between "strangers"—those who have no legal relationship with each other before an accident occurs. Examples include: a car striking a pedestrian; two cars colliding; a passerby on the public domain being struck by a baseball flying from a stadium; a drunk punching someone for no reason in a bar. All of the above are classic tort situations, and all are cases in which there is no prior relation between the parties. In each case there is an externality, and therefore some government intervention, through regulation or through the court system, may be proper.

But many activities now governed by tort law are not of that sort. Instead, in many cases, the parties *do* have prior relations with each other, and therefore there is no externality and no need for government intervention. The major examples are product liability, where a purchaser of a product may be harmed by that product, and medical malpractice, where a patient may be harmed by some action of a physician that the patient has hired. For technical legal reasons, many workplace illnesses or injuries, such as those associated with asbestos, are governed by product liability law. In such cases there is also a prior relationship, although it is more complex. The worker contracts with his employer, and the employer contracts with the supplier of the product.

Since about 1960, as a result of a New Jersey Supreme Court case, *Heningsen v. Bloomfield Motors*, involving General Motors (GM), courts have generally been unwilling to enforce contracts between buyers and sellers involving compensation for harms caused by accidents. No matter what terms the parties may want to govern the results of an accident, the court will decide and impose its own terms. For example, the parties may want to agree that if there is an accident, the producer of the product will pay only for lost earnings and medical costs, and will not pay anything for "pain and suffering." (We will see later that this would be a likely term for parties to agree to.) But if there is an injury, this voluntary agreement will have no effect. The courts will decide what level and type of damage payments from the manufacturer to the consumer are appropriate.

The "Contract of Adhesion" Argument

What is the basis for the courts' intervention? The courts use several related legal concepts to override voluntary contracts. They may say that the parties have "unequal bargaining power," so the contract is a "contract of adhesion" and therefore "unconscionable" or "against the public interest."

Although this family of doctrines is pervasive in the legal literature, it makes no sense. Consider price, for example. In a modern retail establishment, a consumer cannot bargain over price; price is a term of "adhesion" just as much as are the terms of the warranty. In a modern market system, in the short run, almost all product characteristics are characteristics of "adhesion." That is, at any time consumers must take whatever products are offered for sale as given.

Early in this century, when Henry Ford said that a customer could purchase one of his cars in any color as long as it was black, the color of a

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car was a "color of adhesion." But GM offered cars in many colors, thus destroying Ford's claim, as well as its market. In the 1970s when GM failed to make small, energy-efficient cars, one might have said that the size of a car was an adhesion characteristic. Again, however, other sellers, in this case mostly foreign ones, offered the economy cars that consumers demanded.

At one time, retail stores offered goods under terms and prices "of adhesion" until K-Mart and Wal-mart changed those terms and made lots of money in the process. In a market economy, there are powerful incentives for sellers to discover the characteristics preferred by buyers and offer to sell products with those characteristics.

Contract terms are no different than other product characteristics. Firms can compete with respect to warranties and other contract terms, including safety guarantees, just as well as they can compete with respect to any other product characteristic. Indeed, firms do sometimes offer competing warranty terms. Automobile companies often offer a choice of free warranties with car purchases; for example, some companies offer three-year, bumper-to-bumper coverage or a one-year full warranty with an additional four-year limited warranty. Most offer extended warranties for varying prices for different lengths of ing defects may be appropriate. Under a strict liability standard, the manufacturer is liable for harm associated with the defect. Such defects are relatively rare and therefore do not lead to great costs. There is nothing a consumer can do to avoid such defects, since they occur in the manufacturing process. Manufacturers decide how much to spend on inspection and quality control. The costs of determining that a fault has occurred are relatively small. Thus, a strict liability standard for this class of error would likely evolve in a free market. Indeed, there is evidence that the original proponents of strict liability for product-caused injuries had exactly this class of defects in mind.

On the other hand, design defects are quite different. Design defects are said to occur when the courts rule that it would have been possible for the manufacturer to design the product differently and thus make it safer. For example, a court may decide that an automobile manufacturer should have put the gas tank in a different location. Such defects apply to all units of some product, not merely to faulty units.

A manufacturer stressing the safety of its product might agree to pay nonpecuniary damages, and perhaps advertise, "Our product is so safe that if a court ever rules that we have negligently caused a death, we will pay $1,000,000 in additional insurance to survivors."

The great expansion in product liability (discussed below) occurred when the courts extended strict liability from manufacturing defects to design defects. That extension requires courts and juries to second-guess product designers and determine if there was a safer alternative available when the product was manufactured. Such second-guessing is difficult or impossible, so litigation of such issues is very expensive. It is unreasonable to expect a manufacturer to include on a product a safety feature that literally has not been invented. The major problems identified with the current tort system are due to the extension of strict liability to design defects. It is likely that a contractual solution would lead to little or no liability for such defects.

Another major class of modern liability cases involves a "failure to warn." Originally, it was thought that product warnings would insulate manufacturers from liability. However, the opposite has occurred: manufacturers are often found liable for failure to warn, sometimes in circumstances in which consumers have misused products in dangerous and unpredictable ways. In a regime of efficient tort law, one would suspect that some liability for failure to warn would remain, but only for risks that were reasonably foreseeable in normal uses of the product. Liability might also attach to failure to indicate precautions that would allow consumers to avoid injury in normal uses.

Damage Payments. It is useful to divide damage payments into four classes.

Pecuniary damages compensate consumers for actual out-of-pocket expenses, such as medical expenses and lost wages from injuries.

Nonpecuniary damages compensate consumers for other, nonmonetary losses. The most important class of nonpecuniary payments is for pain and suffering.

Payments for *hedonic* losses, or lost pleasure in life, a relatively new and controversial class of payments in the tort system, are also nonpecuniary payments.

Punitive damages are for extremely reckless or grossly negligent behavior, where the goal, in addition to compensating the injured consumer, is to punish the injurer.

Keeping in mind that consumers are paying for whatever damage payments they ultimately receive in the form of higher prices for goods and services, some principles are apparent. Damage payments are like insurance: consumers pay "premiums" in the form of higher prices for products and receive a payment if injured. Since consumers do find it worthwhile to purchase insurance against medical costs and lost wages, it is appropriate that those responsible for injuries should also compensate for such losses, although some coordination between payments from injurers and payments from direct insurers may be useful.

If given a choice, consumers never buy insurance against pain and suffering. There are sound theoretical explanations for this fact. However, without analyzing this decision, evidence suggests that such insurance is not purchased when consumers have a choice. That means that the value of such insurance is below its cost, and since the cost of operating the tort system is higher than the cost of operating any other insurance system, consumers would be even less willing to pay for compensation for pain and suffering through the tort system than in any other form of insurance. Thus, it is likely that a voluntary, contractual system would not provide compensation for nonpecuniary losses.

Punitive damages are a more difficult issue. There are some behaviors of firms that normal tort damages will not adequately deter, such as behaviors that may approach criminality. Moreover, firms will sometimes make efforts to hide their behavior. Thus, in some limited circumstances, punitive damages might be in the interest of consumers. A reasonable approach might be to require a higher standard of proof for punitive damages than for other damages. For example, the standard might be the same as that in criminal law, proof "beyond a reasonable doubt." That would allow some punitive damages, but only in limited circumstances. The higher standard of proof would eliminate many of the extreme cases observed today.

In sum: if contracts were allowed, consumers would probably want strict liability for manufacturing defects. They would probably want to be compensated for pecuniary damages, but not for nonpecuniary damages. In certain limited circumstances, they might also want punitive damages.

If warranties, that is, liability contracts, were allowed, then the terms outlined above are the terms that would likely be agreed upon by buyers and sellers. The terms would be in the warranty. Manufacturers would have the option of allowing different terms and advertising those terms. For example, a manufacturer stressing the safety of its product might agree to pay nonpecuniary damages, and perhaps advertise, "Our product is so safe that if a court ever rules that we have negligently caused a death, we will pay $1,000,000 in additional insurance to survivors."

Magnitude of the U.S. Liability System

We do not have the efficient system described above. Rather, we have an extremely inefficient and expensive tort system. The U.S. liability system costs much more than the system of any other country, and much more than the U.S. system itself cost 30 years ago. As of 1991, total costs of the tort system in the United States were estimated by the international consulting firm Tillinghast at $132 billion, 2.3 percent of Gross Domestic Product (GDP). For the other countries in the Tillinghast sample (Denmark, the United Kingdom, Japan, Canada, France, Switzerland, Spain, Belgium, West Germany, and Italy) the average cost was 0.9 percent of GDP. No other country even approaches our level of spending. The highest country outside the United States is Italy, with tort system costs of 1.3 percent of GDP.

How much of the $132 billion spent on tort liability in the United States is waste? Suppose that the other countries on average provide about the right amount of insurance and deterrence through the tort system; then the difference between U.S. tort costs and this average would be a measure of waste in the system. U.S. tort costs in 1990 were 1.4 percent of GDP higher than costs in the rest of the developed world. Based on a U.S. GDP of $5.546 trillion, the waste in the system was then $82 billion in 1990. That comes to about $900 for each household in the United States. That $900 is paid in higher prices for goods and services and in higher insurance premiums. In other words, if we could only make the U.S. system approximate the tort systems in the rest of the developed world, then the average real income of Americans would increase by 1.4 percent, and each household would have about $900 more to spend on valuable goods and services.

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We can also compare the current U.S. system with the recent past. Even though the changes in the system replacing contract with tort date from the 1960s, it took some time for the changes to work themselves out fully. Costs of our tort system escalated sharply beginning in 1985. In the period 1970 to 1984, tort system costs averaged 1.5 percent of GDP. The major legal changes leading directly to the cost increase in that period were the imposition of strict liability for design defects and for failure to warn, discussed above. If the United States prior to the imposi-

Figure I

International Tort Cost Comparison

Computed from Tillinghast, "Tort Cost Trends: An International Perspective," 1992.

tion of those doctrines is used as the baseline, then the waste of the current system is 0.8 percent of GDP, over $500 per household.

There is no obvious reason why the United States should now spend more on tort law than other countries, or more than we have spent historically. The United States has a well developed—perhaps *too* well developed—safety regulatory system, and there is no evidence that the system is lax relative to the rest of the world in such regulation or that the United States has become less restrictive than it used to be. Indeed, in the area that has been studied most extensively, pharmaceutical regulation, the United States is stricter than the rest of the world. Moreover, the overall level of accidents in the United States has been declining continually, so that there is no increase in accident risk to explain the increase in tort liability.

Unless it is maintained that every other country in the world is on the wrong track, and that the United States has only recently discovered the correct route, American policymakers should realize that real incomes could be much greater—between $500 and $900 greater per household—with a more sensible tort system. Some additional evidence about the magnitude of the gains to be expected from sensible tort reform is available. A recent National Bureau of Economic Research study by Thomas J. Campbell, Daniel P. Kessler, and George P. Shepherd has shown that states that adopted tort reforms reducing the level of liability had significantly higher levels of labor productivity, up to about 10 percent higher in some industries.

Sources of the Current Dilemma

While the tort system imposes costs on consumers, the same is true for much regulation. If one keeps in mind the distinction between contractual and noncontractual relations between firms and consumers, then some principles of efficient regulation become apparent. For example, proponents of environmental regulation usually justify their position by arguing that such regulation regulates externalities in cases where there is no contract.

On the other hand, much safety regulation is not justifiable. The Occupational Safety and Health Administration regulates workplace safety, but workers can contract with employers and demand higher wages for less safe workplaces, providing incentives for employers to make them efficiently safe. The Consumer Product Safety Commission, National Highway and Traffic

Safety Administration, and Food and Drug Administration regulate safety of products where consumers could otherwise choose the degree of safety they prefer. In all of those cases, the government is imposing standards in situations where consumer choice could govern. While some provision of information to consumers by government might be useful, the policy of prescribing certain products and interfering with free choice has no justification.

The problems of the current tort system and those of the regulatory system stem from the same source: the willingness of the New Deal Supreme Court to overturn contracts. Before the New Deal, the Supreme Court generally upheld contracts. The era preceding the New Deal is sometimes referred to as the "Lochner" era, after the 1905 case, *Lochner v. New York*, in which the Court held that a state law limiting the number of hours that bakers were allowed to work was an unconstitutional interference with freedom of contract.

The pre-New Deal Supreme Court had established a complex edifice of rulings that protected contracts and private property. Some of the pillars of that edifice were: the Contracts Clause, which protected contracts; the Commerce Clause, which was interpreted as allowing regulation of interstate commerce but not production; the Takings Clause, limiting the power of the government to take property; and the principle of separation of powers, which was interpreted as prohibiting Congress from delegating power to regulatory agencies. It took numerous legal changes in all of those areas to overthrow the era of free contract that preceded the New Deal.

The New Deal demanded that the Supreme Court overturn all of those restrictions, and the Court ultimately complied. The result has been a tremendous expansion of government regulation of all sorts. The explosion of tort liability is only a small twig on the tree of government growth watered by the New Deal Court. If we return to a world wherein adults can make contracts with each other that are enforced by the courts, then many of our problems will be solved, in both the tort system and the economy more generally.

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Do *Not* Federalize Tort Law

A Friendly Response to Senator Abraham

William A. Niskanen

Congress may soon pass the first major federal tort statute. Federalizing tort law would be quite inconsistent with the general devolutionary theme of the Republican agenda. The Republicans should trust their principles; federalizing tort law would also be a major mistake.

In March the House approved a broad bill that would limit damages in all civil cases, including those filed in state courts. The House bill would impose a cap of $250,000 on noneconomic damage awards in most medical malpractice cases and would preempt state tort laws unless they are more stringent than federal provisions. The bill would also cap punitive damages in all civil cases at three times the award for economic damages or $250,000, whichever is greater, and would eliminate joint and several liability in all civil cases.

In May the Senate approved a narrower bill limited to product liability cases, including those filed in state courts. The Senate bill would cap punitive damages in most cases at twice the award for compensatory damages or $250,000, whichever is greater, allowing judges to waive the limit under specific conditions. The Senate bill would also eliminate joint and several liability.

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As I write, the conference committee has yet to resolve the differences between the House and Senate bills, and an early floor vote is not anticipated. President Clinton has signalled that he is likely to sign some version of a tort reform bill.

May I first acknowledge that American tort law, especially as it has developed during the past 30 years, should be changed. Many victims are undercompensated, some victims receive outrageous awards, and the transactions costs are unduly high. Insurance premiums for medical malpractice and product liability have become a major burden without any significant incremental effect on health and safety conditions. Not all nationwide problems, however, demand national solutions. The problems of American tort law are serious and demand attention, but federalizing tort law would be a major mistake. Let me count the ways:

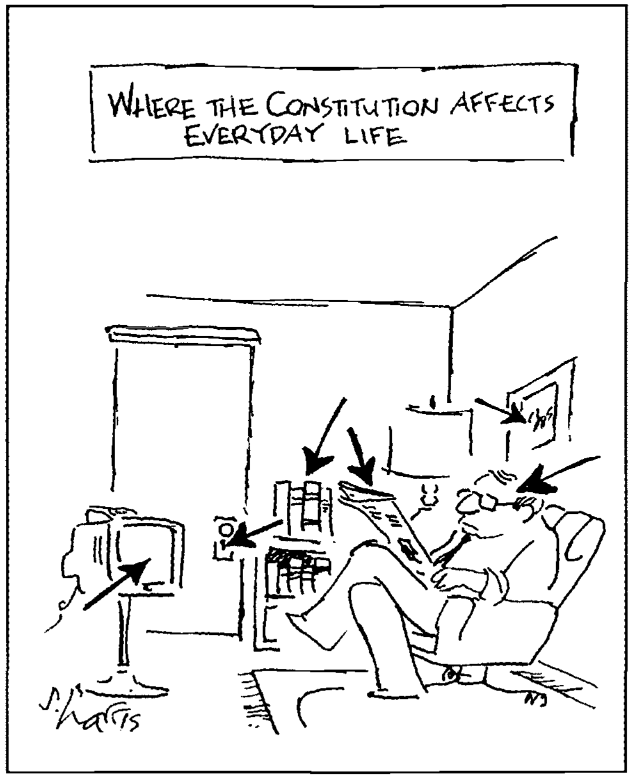
Congress May Lack the Authority to Make Tort Law

The Constitution authorizes Congress "To regulate Commerce . . . among the several States," a power first authorized and long interpreted as a protection against state barriers to interstate commerce. For the past 60 years until the recent *Lopez* case, however, the Commerce Clause was interpreted to authorize federal regulation of almost any type of activity within individual states; Congress cited this broad interpretation of the Commerce Clause, for example, as the authority for federalizing much of the criminal code in 1994. The general issue, thus, is whether the Commerce Clause is to be interpreted narrowly or broadly. In the *Lopez* case, the Supreme Court ruled that the federal government lacks the authority to ban guns within 1,000 feet of a school on the basis that this condition constitutes neither commerce nor an interstate act. A majority of the current Court, however, would probably affirm federal regulation of an activity that has a substantial effect on interstate commerce, even if it does not represent a barrier.

For our present discussion, the specific issue is whether the developments in the common law and state statutory tort law are a barrier to interstate commerce or are merely a burden on all commerce. In the former case, there is no question of the federal authority. In the latter case, a federal tort law would probably be affirmed by the current Court, but not by a more strict constructionist Court.

Sen. Spencer Abraham (R-Mich.) addressed these issues this summer in a thoughtful article in the Heritage Foundation's *Policy Review*. Senator Abraham first acknowledges that "We must . . . limit intervention from Washington according to the principles of federalism and with an understanding that the potential risks of national intervention are always high." He makes the case for federal authority, however, on the basis that the burden of tort law constitutes a "litigation tariff." And he concludes that "the status quo is bad enough that congressional intervention . . . is quite unlikely to make it worse." On both issues, I respectfully disagree.

The cost of tort law is a burden on all commerce in a state, but it is not a specific barrier to commerce among the states. The effects are more like those of a retail sales tax on all products sold in a state than of a differential tariff on products imported from another state. The average effective liability tax rate is probably about 2.5 percent, but the effective rates differ substantially by product and by state. There is ample evidence that courts favor in-state plaintiffs over out-of-state defendants, but there is no evidence (to my knowledge) that the courts favor in-state defendants over out-of-state defendants. In the absence of evidence of relative discrimination against out-of-state defendants, there is no basis



for considering the cost of tort law to be a litigation tariff. The tort law or sales tax in a state may be unduly burdensome on commerce in that state, but that should not be sufficient basis for federal measures to harmonize either tort law or sales taxes.

My judgment, in addition, is that Senator Abraham underestimates the potential for Congress to make things worse. There are several serious concerns about the House and Senate bills by other than the trial lawyers. And the scope of the effects of mistakes by the federal government is much larger than that of the same mistakes by an individual state. More important, over time, federal mistakes are subject to a weaker corrective process than the evolutionary processes that affect the common law and state statutory law. (More on this issue is in the subsequent sections.)

In the end, it is not clear that Senator Abraham believes his own case. For example, he would allow states to opt out of the federal tort law for disputes between parties in the same state and to opt out of specific provisions of the federal law such as the cap on punitive damages and the ban on joint liability. In the near term, a federal tort law would change the law in ways some states might not otherwise choose. In the long term, a federal law with Senator