

Topics in the Economics of Tort Liability

Lecture 7



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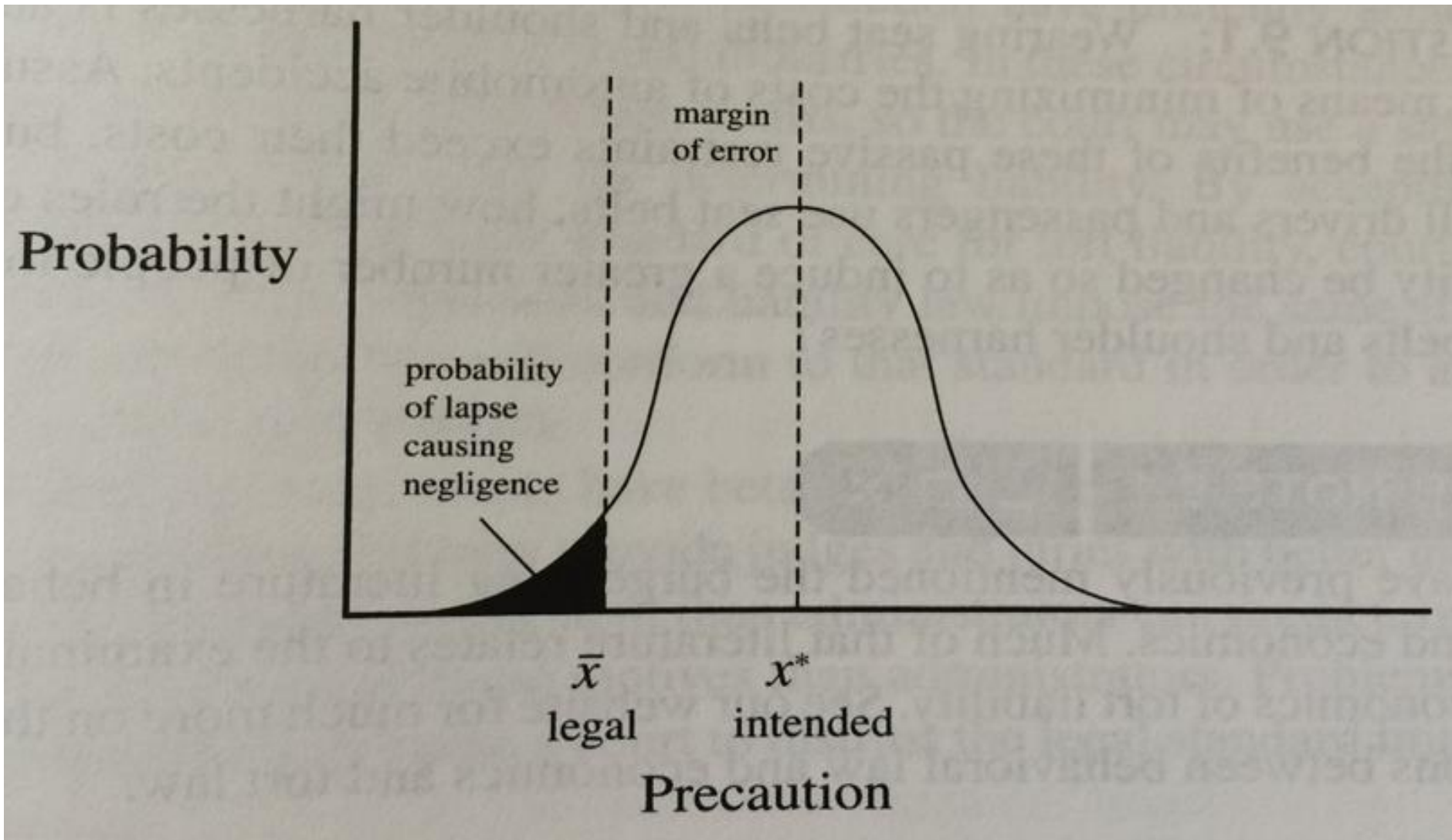
Extending the Economic Model

Relaxing initial assumptions:

- decision makers are rationally self-interested
- there are no regulations designed to reduce external costs
- there is no insurance
- all injurers are solvent and pay damages in full
- litigation costs are zero

Rationality

- Stable, well-ordered preferences-required for effective tort liability system
- Kahneman, Tversky-*people underestimate low-probability events and overestimate low-probability errors*
- *Implications*-decision makers may overestimate or underestimate $p(x)$ -too much or too little precaution
- accidents result from inattention, misjudgement, misperception
- “lapses”-unintended X intended negligence, (example of motorist and consequent liability)
- *Moral luck determines liability-unfair*



Lapses and Accidents

- lapse as a probabilistic connection between intended and actual precaution
- achieve precaution level x^* - exceeds a legal standard
- when actual precaution falls below intended precaution=„lapse“
- Shaded area-the probability of lapse causing negligence
- The actor gains private advantage by exceeding the legal standard, but *precaution socially optimal if MC of taking a little more precaution equals MSB of fewer accidents*
- Replacing a rule of liability for accidents caused by negligence with a rule of liability for accidents caused by intentional negligence

Regulations

- **Regulation**-ex ante enforcement by administrators
- **Liability**-ex post enforcement by victims
- if safety regulation and liability law impose the same standard of care-potential injurers will conform in order to avoid both ex ante fines and ex post liability
- Sometimes standards too low or too high (bribes)
- Undercapitalized firms-escape liability through bankruptcy-safety standards better
- Administrative costs of regulation and liability

Insurance

- **Subrogation**-the insurance contract transfers the victim's recovery rights to the insurance company
- a rule of no liability-potential victims buy accident insurance and potential injurers have little need for liability insurance
- A rule of strict liability-potential injurers need liability insurance and potential victims have little need for insurance against those accidents for which the injurers are liable.
- Moral hazard (reduction-deductibles, coninsurance, experience rating, safety standards)
- No liability or strict liability? „Unwanted insurance“
- Is the insurance company inherently unstable?

Bankruptcy

- Example: Company for hazardous waste. In order to avoid future liability, it will use extreme care in dumping hazardous waste. Or it might follow the strategy of dumping recklessly and accumulate tort liability, which exceed its assets, (by continuous distribution of profits and undercapitalization thereby). When harm materializes and suits begin, the firm declares bankruptcy.
- Other possibilities- separate company (of parental company) not responsible for a bankrupt subsidiary, securitization
- Solution to this distortion? Compulsory insurance, posting bond or replacing ex post liability with ex ante regulation, replacing rules of strict liability with negligence rule

Litigation Costs

- the impact of costly litigation on potential victims, (no signal, lower precaution, more accidents)
- the impact of litigation on potential injurers (more precaution)
- high litigation costs-counterintuitive implication

Extending the Basic Model-Vicarious Liability

- one person may be held responsible for the torts committed by another, the third party is said to be vicariously liable for the tortfeasor's acts
- **The doctrine of respondent superior** (let the master answer)-employers responsibility for the tortious wrongs of their employees, (example with truck)
- Strict vicarious liability rule-the employer is liable for harms caused by an employee
- a rule of negligent vicarious liability-the employer is liable for harms caused by *negligent supervision* of an employee
- Which rule to apply? Careless nurse X sailor on a tanker

Joint and Several Liability with and without contribution

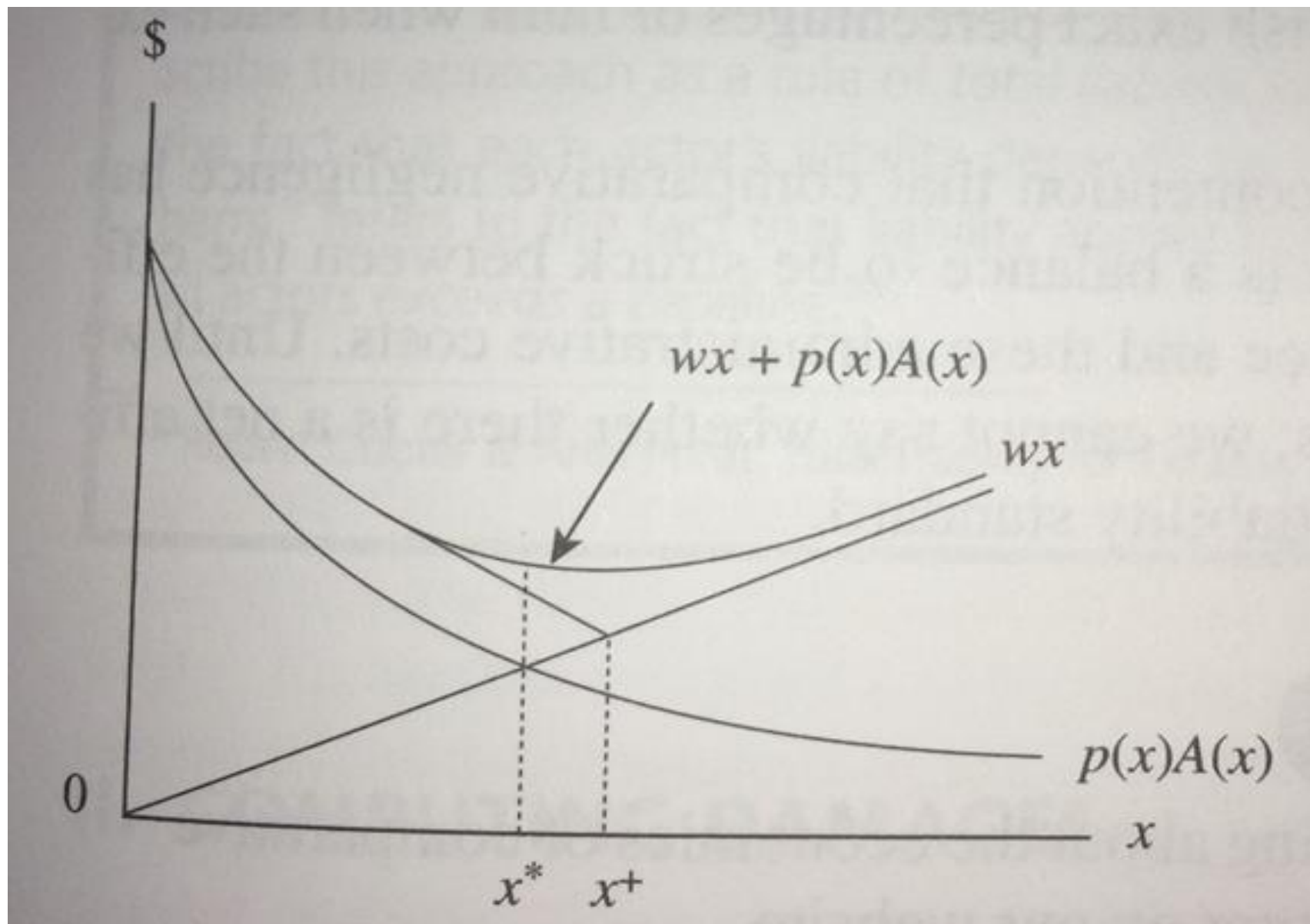
- Joint and several liability-if each of defendants is liable for all the victim's full losses, not just a portion of them
- conditions:
 - 1) if the defendants acted together to cause the victim's harm
 - 2) If victim's harm indivisible
- under common law-defendant has a right of contribution from other..,(unintentional torts only)
- several liability with contribution-the most generous for plaintiff
- joint liability with contribution-the least generous for plaintiff

Joint and Several Liability with and without contribution

- it relieves the victim of the potentially high costs
- deep pocket-victim's recovery more certain
- Efficiency of contribution rule (limits the total recover to the actual harm)
- Other rules: the possibility of multiple recoveries (eager victim) X no contribution rule

Evidentiary Uncertainty and Comparative Negligence

- the rule of contributory negligence-contributory negligent plaintiff could not recover anything from the defendant, even from negligent one
- comparative negligence the plaintiff's contributory fault is a partial but not a complete bar to recovery from a negligent defendant. The negligent injurer *usually owes something, but not full compensation* to the negligent victim.
- *Evidentiary uncertainty*-litigation costly, uncertain how the court will evaluate the evidence
- *Evidentiary uncertainty will cause potential injurers to go beyond the level of precaution –“overprecaution“*
- *Under rule of comparative negligence-the level of precaution lowest*



Computing Damages-Hand Rule Damages

- the court should consider situations in which risk is reasonable.
- value p for the probability of a fatal accident
- B ...the burden of precaution
- Efficiency requires taking additional precaution until the burden equals the change in probability p multiplied by the loss L
- $B=pL$
- The value of fatal risk $L=B/p$
- Hand rule in unusual way- the decision-maker uses the accepted legal standard of care that an individual violated to determine his liability.
- Hand rule in usual way-to determine whether the injurer's precaution satisfied the legal standard
- This second method useful in case of legal and moral barriers to markets, (incompensable losses-child)

Computing Damages-Punitive Damages

- Example: In 1984 Getty Oil agreed to sell itself to Pennzoil, but the Texaco oil company encroached on the deal and bought Getty. In a lawsuit a Texas jury awarded 7.53 billion USD in compensatory damages to Pennzoil and 3 USD billion in punitive damages, (in the end plaintiff settled out of court because the full judgment would have bankrupted the defendant). Not mutual agreement whether defendant committed the wrong. The award of punitive damages unforeseeable.
- punitive damages-given to the plaintiff as a way of punishing the defendant

Computing Damages-Punitive Damages

- Much uncertainty how to compute, no specific instructions
- Economic analysis-guidelines:
- Without punitive damages, decision-maker's liability L is limited to compensatory damages A , which are imposed with enforcement error e in the event of an accident:
 - $L=Ae$
 - To offset the error, impose the punitive multiple m , so that liability is given by:
 - $L=Aem$
 - Set punitive multiple equal to the reciprocal (inverse) of the enforcement error: $m=1/e$
 - Punitive multiple offsets the enforcement error, liability reduces to $L=A$

An Empirical Assessment of US Tort Liability System-General Facts

- More than 60% of the tort cases in the 75 largest counties deal with automobile accidents. The next most common tort dispute is arising from premises liability-17%, (slips and falls or other injuries at residences, governmental offices, commercial establishments), medical malpractice-5%, products liability-3,4%
- Punitive damages too often, too liberally
- anecdote: mid of 1990 a woman who was scalded when she spilled a coffee from a MC Donald drive-through window- 640 000 USD in compensatory damages and 2.9 million in punitive damages for her injuries

Medical Malpractice

- The Institute of Medicine-(2000)-“Medical errors are the leading cause of accidental death in the USA.” (ranging from 44000 to 100 0000 deaths per year in 1997). Medication errors alone account for approximately 7000 deaths per year, exceeding the number of deaths due to workplace injuries.” Number of malpractice increased between 1960-1980s. Slowed down in 1990 due to statutory reform.
- monetary incentives deficient!! „liability insurance transfers the cost“
- „defensive medicine“

Products Liability and its reforming

1. a defect in design

2. a defect in manufacture

3. a defect in warning

Products-liability law-precaution is unilateral-then strict liability
-bilateral- negligence rule

- Calls for unified product liability law
- putting a cap on upper limit on the amount and kind of damages that victims can recover (hot coffee spill)

Mass Torts

- a large number of tort claims arise from a single incident or use of the same product

Example: Problems arising from asbestos. Or Bhopal disaster in 1984 in India—a cloud of highly toxic chemical escaped from the Union Carbide plant and killed between 15000 and 20 000 people and injured thousands more.

-relying on standard tools of tort liability—may cause injustice

-market share liability

-the creation of a trust fund to provide limited compensation to victims of asbestos, (not enacted)

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