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A Look at the Inefficiencies of the U.S. Tort System and Reforms to Correct Them

Ryan Koopmans

ABSTRACT. The two goals of tort law are to compensate victims and to deter unsafe behavior. This paper judges whether changes are needed in the current system by looking at how well it meets these goals. The current system is inefficient and ineffective. Three reforms are analyzed and suggested: contingency-fee reform, the elimination of punitive damages for corporations and large business, and the creation of a no-fault system of compensation for the worst areas of tort law. By enacting these reforms billions of dollars could be saved, while leaving the goals of tort law intact.

I. Introduction

The word Tort comes from the Latin word *tortus*, which means twisted or crooked. This is ironic since many Americans would describe the U.S. tort system, and anyone involved in it, as crooked. Everyday stories are told about plaintiffs *winning* thousands of dollars in frivolous lawsuits. For example, a teenager who caught his teeth in a basketball net while trying to dunk a basketball won \$50,000 from the manufacturer of the net [MDCALA, 2003]. Cases like these have led many Americans to demand that the tort system be reformed.

While frivolous lawsuits are a problem in the U.S. tort system, this paper looks at the efficiency and effectiveness of the entire system, setting aside the issues of frivolous claims. Two questions will be examined and answered here. Does the U.S. tort system accomplish its goals efficiently and effectively? If not, what reforms should be enacted to create a system better suited for the U.S.?

To answer these questions the goals of tort law must be understood. Tort law has two roles: to compensate victims and to deter unsafe behavior. Compensating victims serves two purposes. First, society feels that if someone is harmed in some way then he should be allowed to recover damages. By using a court of law to recover damages, victims are discouraged from seeking retribution in some other form. The second reason for compensating victims is to encourage them to take the proper amount of precaution while going through their daily activities. Extremely high levels of precaution may be inefficient to society. Compensating someone who was harmed, but took the proper amount of care, is

therefore beneficial to society. The goal of deterring unsafe behavior is accomplished by making the injurers pay damages to the victim. Making the injurers pay damages forces them to internalize the cost they impose on others and gives them incentives to act to benefit society as a whole.

Damages awarded to victims are of two types, compensatory and punitive. Compensatory damages are intended to make the victim whole [Cooter, 1998, 306]. In other words, compensatory damages seek to make the victim indifferent between having the injury and the damages, and having neither. Punitive damages are not meant to compensate the victim, but instead are intended to punish the injurer.

By examining tort law under the goals of compensation and deterrence, this paper finds that the current U.S. tort system is inefficient and ineffective. To correct the problems of the current system three reforms will be suggested.

II. Compensation Under the Current System

Knowing the amount of lawyers' fees and administrative costs that are incurred when compensating victims allows one to determine the efficiency of the system. A study by Tillinghast-Towers Perrin [2003], breaks down the transactions of the tort system into insurance company administrative costs, defense costs, claimants attorney fees, economic damages, and non-economic damages.

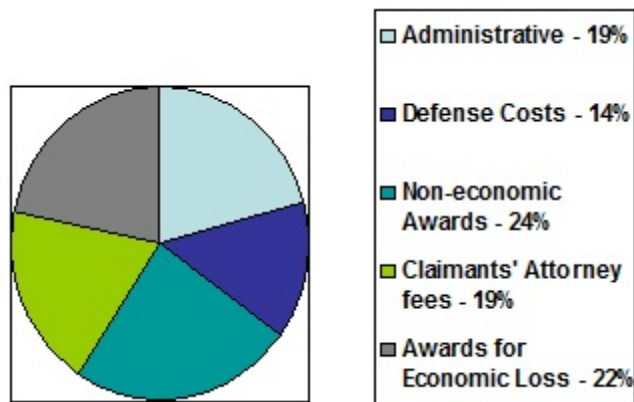


Figure 1

The total amount of transactions that took place in the tort system in 2003 totaled \$233 billion [Tillinghast, 2003]. The results are shown above in Figure 1.¹ According to Tillinghast, only \$107 billion of the \$233 billion went towards compensation. Gauging the tort system on the basis of compensation, the current system is inefficient.

III. Contingency-Fee Reform

How has our tort system become so inefficient? In recent years much of the blame has fallen on the plaintiffs' attorneys. Most plaintiffs' attorneys are paid on a contingency basis in tort cases. That is, they are paid a percentage of their clients' monetary award. "Since 1960 the effective hourly rates of tort lawyers has increased 1,000 to 1,400 percent, adjusted for inflation..." [Brickman, 2003, 655]. It is also not unheard of for contingent-fee tort lawyers to generate fees amounting to tens of thousands of dollars an hour [Brickman, 2003, 660]. On average, tort lawyers are making three times as much as their defense counterparts [Brickman, 2003, 655]. Still, opponents of contingency-fee reform will point out that contingent-fee lawyers are not paid if there is no monetary award and they need to be compensated for that risk. Tort lawyers do take on risk, but the hourly fees have increased over 1,000 times since 1960 while the overall risk of non-recovery has remained constant [Brickman, 2003, 655]. Risk cannot explain the run-up in claimants' attorney's fees. Contingency-fee caps should be put in place. Contingency-fee caps would limit the percentage a lawyer could take from claimant's monetary award and put the hourly rate of tort lawyers in line with the hourly rate of defense lawyers.

IV. Compensation Under a No-Fault System

Contingency-fee reform opponents also argue that contingency fees allow individuals access to the civil justice system who would otherwise not be able to afford it. This argument does hold some weight, but there is a better way to serve the same purpose. Attorneys' fees can be eliminated almost entirely by putting in place a no-fault system of compensation. In a no-fault compensation system victims do not have to prove any form of negligence to receive compensation. For example, if someone is injured on the job, they are entitled to Workers' Compensation without having to

prove any type of fault. “Workers compensation is a model of efficiency when compared to the tort system” [Stocker, 2003, 21]. Workers’ Compensation administrative costs, including lawyers fees, are 20 percent of damages paid to claimants [Stocker, 2003, 21]. The Federal Workers compensation system is even more efficient. In 2001 total benefits paid out by the system were \$2.2 billion, while administrative costs were only \$109 million, or 4.9 percent of damages paid to claimants [National Academy of Social Insurance, 2003, 39]. If even 20 percent is a reasonable percentage of what administrative costs should be, then the conversion of the entire tort system to a no-fault system would save almost \$100 billion (This figure is found by taking the amount of damages paid to claimants, \$107 billion and multiplying that by 20 percent, which equals \$21.4 billion. To calculate the savings, subtract \$21.4 billion from \$121.16 billion).

Admittedly, the conversion of the entire tort system into a no-fault system is unrealistic. There are, however, many cases in which the implementation of a no-fault system would prove to be effective. Medical Malpractice litigation, which cost \$13 billion in 2002, and provided \$11.6 billion in damages to claimants [Tillinghast-Towers Perrin, 2003, 29] is one such case.

Medical malpractice premiums have increased substantially over the past few years. Rates have escalated rapidly for doctors who practice internal medicine, general surgery, and obstetrics/gynecology. The average increase ranged from 11 to 17 percent in 2000 and a more recent report revealed rate increases are averaging 20 percent per year [U.S. Department of Health and Human Services, 12, 2003]. In some states the increases have been as large as 30 to 75 percent, “although there is no evidence that patient care had worsened” [U.S. Department of Health and Human Services, 12, 2003]. The large increase in medical malpractice insurance eventually translates into rising costs of health care. In the hope of reducing their medical malpractice premiums many doctors practice defensive medicine—costly precautionary treatments administered with a minimal expected medical benefit, out of fear of being legally liable if something happens unexpectedly to the patient [Kessler, 1996, par. 2-3].

While there are no large national no-fault systems for healthcare, small no-fault systems have existed for two decades. “The first actual implementation of no-fault for medical liability occurred in the late 1980’s for newborns with severe birth-related neurological impairments in Virginia and Florida, largely under the Workers’ Compensation model”

[Sloan, 1997, 72]. The goals of the program were to keep liability insurance available, to prevent the practice of defensive medicine and to cover the costs of a very needy eligible population [Sloan, 1997, 72].

In 1995 Frank Sloan and Peter Rankin compared the cases that passed through the no-fault system with cases of a similar nature that went through the tort system in Florida. Since these cases were in the same state, settled in the same year, and of a similar nature, Sloan and Rankin were able to effectively isolate the benefits of the no-fault system.

The results showed that a no-fault system is more efficient than the tort system. In the no-fault system the average amount of compensation for each case was \$486,324, while administrative costs (including claimants' attorney fees) were \$55,549 [Sloan, 1997, 94]. Under the tort system the average amount of compensation was \$399,061 and the administrative costs were \$351,837, with the largest percentage, \$199,530, going to pay for the plaintiffs' attorney fees [Sloan, 1997, 94]. In this instance the no-fault system provided greater compensation, and total costs averaged \$209,025 less per case than in the tort system. The no-fault cases were also resolved a year faster than most comparable tort cases [Sloan, 1997, 90]. With 180 people choosing to go through the no-fault system \$37,624,500 was saved in direct cost alone. The likely decrease in medical malpractice insurance and health insurance premiums added to the total savings.

A similar no-fault system was set up in 1986 for childhood vaccinations. Most of the vaccines currently in use to prevent childhood diseases were developed in a legal environment that protected the manufacturers from litigation. The environment started to change in the 1970's and by 1987, 96 percent of the price of the vaccine for diphtheria, pertussis, and tetanus went towards litigation [Manning, 1994, 248]. Specifically, between 1970 and 1987 the price of the vaccine increased 6,000 percent, largely in response to rising litigation costs [Manning, 1994, 248]. Because of the substantial increase in litigation, insurance premiums increased. The increase in insurance premiums forced some vaccine manufactures to stop production, causing U.S. stockpiles to become dangerously low [Ridgeway, 1999, 61].

In the wake of these events Congress passed the National Childhood Vaccine Injury Act in 1986 [Ridgeway, 1999, 61]. The act set up a no-fault compensation system for children who were harmed by vaccines. As a result, early childhood vaccination rates have increased, wholesale

vaccine prices have decreased, and since 1990 no commercial vaccine manufacturer has ceased production [Ridgeway, 1999, 61].

A no-fault compensation system is a somewhat radical idea, but the two examples discussed above prove this form of liability system can efficiently and effectively compensate victims in specific areas of tort law. The most significant evidence for or against no-fault systems may be yet to come. Shortly after the terrorists attacks on September 11, 2001, Congress put in place a no-fault system called the Victims' Compensation Fund. The main purpose was likely to shield the airlines and other companies from the barrage of litigation that would follow. In exchange for compensation the victims give up their right to sue, which may save many of the already troubled airlines from bankruptcy. Established just a short time ago, the fund is still paying out awards and there is no evidence on how effective the system will be. If the fund is successful, it may become a model for future mass tort cases.

Asbestos litigation is the longest running mass tort in U.S. history [Carroll, 2002, 1]. Over 600,000 claims have been filed against more than 6,000 defendants [Carroll, 2002, 77]. \$23 billion has been awarded to claimants, but \$30 billion has been spent on lawyer's fees and administrative costs [Carroll, 2002, 77]. In other words, costs are more than a \$1.30 for every dollar of compensation. The asbestos cases may be the most inefficient of all tort cases. The indirect costs may be even greater than the direct costs. There have been 56 bankruptcies since 1980 due to asbestos litigation. There were sixteen in the 1980's, eighteen in the 1990's and 22 between 2000 and 2002 [Carroll, 2002, 77]. With companies rapidly filing for bankruptcy, claimants are going after companies that are further removed from the asbestos and building products industries that were directly involved. This raises questions of the deterrence objective of tort law. If companies feel that tort outcomes have little to do with behavior then they will not act in a way that minimizes the total costs to society [Carroll, 2002, 86].

Since so many claimants and defendants are involved in asbestos litigation, government funding will be needed to create a successful fund. The 9/11 Victims' Compensation Fund should provide direction on what works and what does not, for an asbestos fund that is badly needed. Direct costs savings alone could be in the range of \$100 to \$132 billion by the time the last case is resolved [Carroll, 2002, 87].

Some will argue that the establishment of a no-fault system for the costliest tort cases will increase the number of claims. But to erase the

savings gained by creating a no-fault system the number of cases will have to double. This is not likely to happen.

V. Punitive Damages

Punitive damages are often the most excessive damages awarded. Their purpose is to punish the injurer and deter future behavior that is unfavorable to society. Punitive damages are sometimes defined as damages “awarded when the defendant’s behavior is malicious, oppressive, gross, willful and wanton, or fraudulent” [Cooter, 1998, 312]. No official rules exist to guide juries in their decision. The lack of guidance given to juries leads them to award punitive damages on a random basis. In recent years punitive damage awards have been substantial, running into the millions and in some cases billions of dollars, yet there is no predictability from case to case [Viscusi, 1998, 285].

In 1998 W. Kip Viscusi, a professor at Harvard University and a leading figure in law and economics, studied the effect of punitive damages by comparing the behavior of companies in states that do not allow punitive damages with the states that do. He found no evidence of any deterrence effect and claimed that “this lack of evidence is consistent with the proposition that punitive damages are random” [Viscusi, 1998, 381]. If punitive damages are random and provide no deterrence effect, they will act as a tax on companies. Like any other tax the “tort tax” creates a deadweight loss for society [Council of Economic Advisors, 2002, 5]. The President’s Council of Economic Advisors report that a conservative estimate of the deadweight loss incurred by the “tort tax” in 2000 was \$24 billion [2002, 12]. Since 2000, total tort costs have increased almost 30 percent [Tillinghast-Towers Perrin, 5, 2003], increasing the Council’s estimate to \$31.2 billion.

Not everyone shares Viscusi’s view on the purpose and effect of punitive damages. Professor David Luban of Georgetown University published an article in direct response to Viscusi’s study. Luban claims that “the retributive aims of punishment are just as important as its deterrent aims” [Luban, 1998, 359]. This may be a legitimate argument when dealing with individuals, but the largest punitive damage awards are paid by corporations. Corporations are not people who can be punished for bad behavior. Corporations are made up of shareholders, employees, and customers. If retribution is a goal of punitive damages then the

shareholders, employees and customers will be punished [Viscusi, 1998, par. 9]. Viscusi points out that even if the responsible employee is identified, that individual will not suffer the full effects of the punitive damages award and the employee can simply quit his job to avoid any repercussions [Viscusi, 1998, par. 9]. The result is that innocent people who are not responsible for the unsafe decision will suffer the economic sanction [Viscusi, 1998, par 9].

Luban also thinks there is another reason for punitive damages—they act like a bounty for the bounty hunter [1998, par. 37]. He argues that the government cannot efficiently enforce every law, so plaintiffs' attorneys act like a private attorney general, or "bounty hunter" [1998, par. 37]. The idea of the "bounty hunter" is economically sound. Luban's logic is flawed, however, when looking at the size of the bounty. For a system to be efficient resources must be allocated where they are needed the most. The allocation of \$44.27 billion² [Tillinghast-Towers Perrin, 19] to tort lawyers is not efficient. Whatever marginal benefit punitive damage awards may have on safety (Viscusi says there is none) is outweighed by the marginal cost of providing it. Since claimants' attorney fees make up a large portion of the cost it seems that the "bounty" is too large.

Besides being random there are other reasons why punitive damages do not affect behavior. For one, firms are already aware they will have to pay compensatory damages for any harm they cause. Competition also forces firms to produce a safe product that benefits society, or they risk losing market share to other firms. The threat of losing market share to a competitor may in itself prevent a firm from producing an unsafe product. While not all tort cases deal with product liability, government regulation also affects a firm's actions. Corporations and other companies are monitored by numerous government agencies. Through fines and criminal action, government agencies deter firms from engaging in activities that are not in the public's best interest, lessening the need for tort law. In fact, regulation in many cases is more efficient and effective than tort law.

Harvard economists Edward Glaeser and Andrei Shleifer argue that regulation is more efficient than the tort system for two reasons [2002, 4]. One reason is that subversion is greater in the tort system than in regulation [Glaeser, 2002, 4]. In Glaeser and Shleifer's model, subversion includes such techniques as intimidating or bribing judges and juries, and using delay tactics to drive up the defendant's defense costs [2002,4].

Substantial legal fees may cause the defendant to choose to settle the case even though they may not be at fault.

Regulation is also more efficient than the tort system because regulators are more specialized than judges or juries [Glaeser, 2002, 5]. This seems to be an obvious point. For instance, an investigator for the U.S. Consumer Products Safety Commission would have more knowledge than a judge or a jury as to what products are unsafe for consumers. Judges hear hundreds of cases a year, most of them having nothing to do with product liability. Their knowledge of the mechanical workings of a product is considerably less than someone who looks at consumer products on a daily basis. A jury may not have *any* knowledge of the subject.

Since government regulation is more efficient than the tort system and because firms are already deterred by the threat of compensatory damage awards, punitive damages should be eliminated for corporations and private businesses. Ending punitive damages would eliminate a substantial amount of the deadweight loss incurred by the “tort tax.”

VI. Effects of Tort Reform Laws

In 1995 a study was published that compared productivity and employment in states that enacted tort reform laws with states that did not. Reforms that limited contingency fees and punitive damages were among the reforms studied. The authors discovered that states that enact tort reform laws which reduced liability increase productivity growth in a broad range of industries. In contrast, states that enacted laws that increase liability decrease productivity growth. Similarly, states that enact laws reducing liability show an increase in employment growth, while liability increasing laws reduce employment growth [Campbell, 1995, 27]. The industries helped the most were the ones whose products were produced and consumed in the state enacting the tort reform law. This is because “the state in which production occurs is the same as the state in which liability accrues” [Campbell, 1995, 18].

Maybe the most interesting finding of this survey was the effect of tort reform on the legal industry. In the short run legal fees decrease slightly, but in the long run the tort reforms benefit the legal industry. Liability increasing reforms, on the other hand, significantly hurt the legal industry [Campbell, 1995, 20]. Shocking as this finding may be, it makes

sense. Lawyers perform a wide variety of tasks in the U.S. economy other than pursuing or defending tort claims. The increase in productivity will make the economy better off and the demand for other sorts of legal services will increase.

VII. Politics in Play

The evidence is convincing that tort reform is needed. Specifically, laws should limit contingency fees, eliminate punitive damages for companies, and set up no-fault systems for the worst tort cases. So why are state legislatures and the U.S. Congress so slow to enact these reforms? In the U.S. Senate two major tort reform laws have been blocked by Democrats in the past year. One of the reforms would have set up an asbestos compensation fund for the victims of asbestos related diseases. While there are many reasons Democrats oppose tort reform bills, the large campaign contributions of the Association of Trial Lawyers of America (ATLA) may be the number one reason.

In 2003, ATLA was the second largest contributor to the Democratic Party [Center for Responsive Politics, 2004]. In 2002 ATLA was the third largest contributor to the Democratic Party, and they rank fourth, all time, as the largest contributor to any political party [Center for Responsive Politics, 2004].

VIII. Conclusion

Tort law provides a necessary remedy for those who have been injured. It also provides an incentive for producers to make safe products that benefit society. The current tort system, however, is not efficient or effective. The cost of compensating victims is more than the compensation. Punitive damage awards are unpredictable and do not provide the proper incentives to producers, resulting in a deadweight loss to society. The reforms discussed in this paper correct many of the inefficiencies of the current tort system without lessening the compensation given to victims. Moreover, government regulation and the threat of having to pay compensatory damages already gives companies the incentive to produce products and services that are beneficial to society. Legislators should enact these reforms into law.

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Endnotes

1. The results of this study have been widely quoted by both proponents and opponents

of tort reform, suggesting that the analysis of the tort system's cost is informative as well as objective and unbiased [Tillinghast-Towers Perrin, 2003,5]. Subsequently, Tillinghast testified before the U.S. Congress Joint Economic Committee as well as the United States Senate Judiciary Committee in October, 2003 [Tillinghast-Towers Perrin].

2. Total tort U.S. tort transactions=\$233 billion. Claimants' Attorney fees=19%