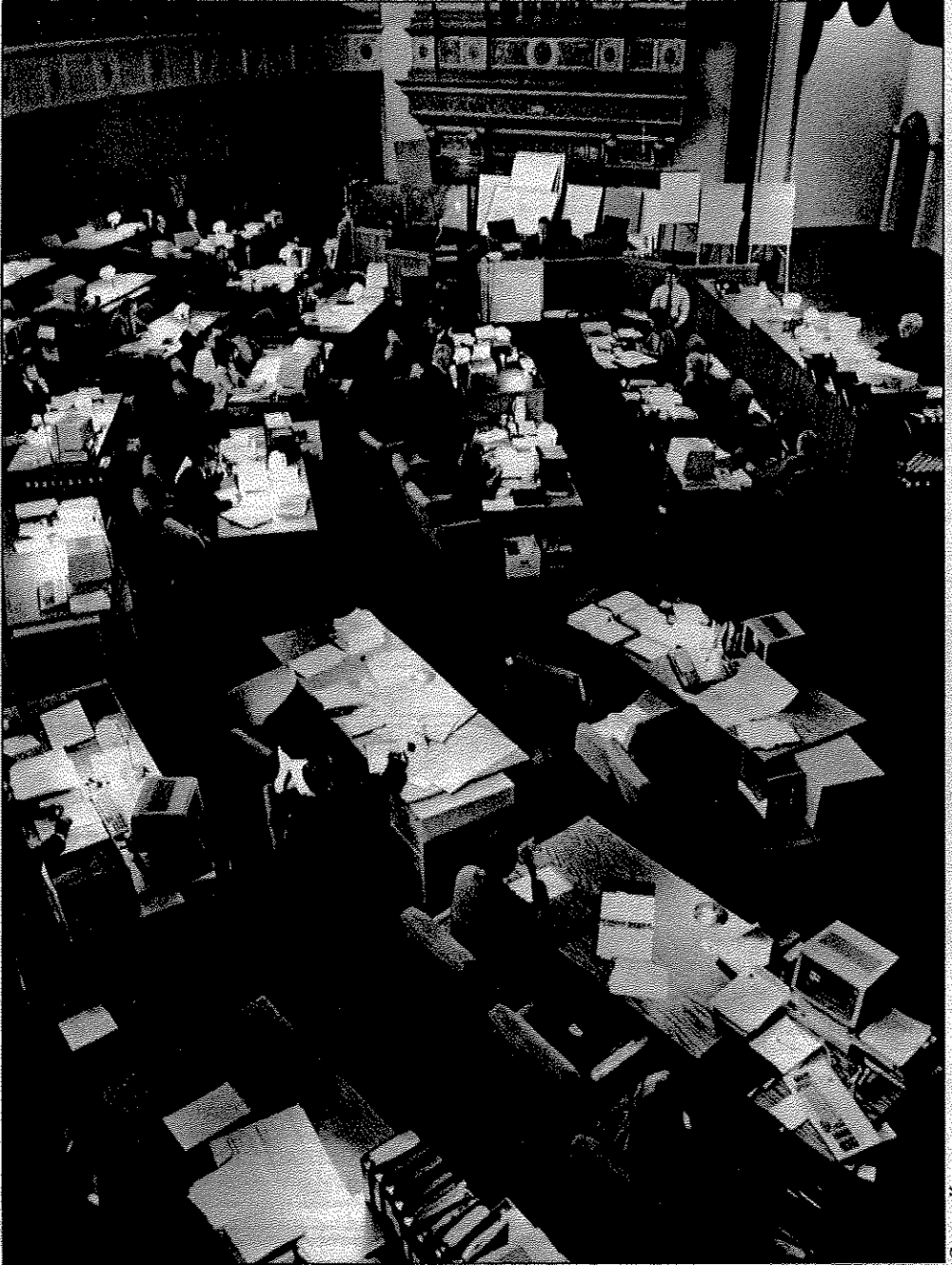


Manhattan Report

The Liability Crisis:



George Kruse

Who's To Blame?

MANHATTAN REPORT

The *Manhattan Report* is published by the Manhattan Institute for Policy Research, an independent, non-profit research organization established for the purpose of assisting scholars, government officials, and the general public to gain a better understanding of economic issues and policy.

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Cover—An “asbestos contamination” trial being held in the massive Nourse Auditorium in San Francisco with over 60 litigants.

Editor's Notes

No public issue in recent memory has emerged so quickly and with such widespread impact as the liability crisis. Every major industry and occupation in the country has been affected by the rapid upsurge in tort litigation. Numerous products have been taken off the market for fear of costly lawsuits and an increasing number of professionals, from doctors to social workers, are unable to obtain the insurance necessary to practice their craft.

Numerous theories have arisen as to why the liability crisis has emerged—each one of them pointing to a different set of reforms. Consumer advocates argue that the current shortage in insurance coverage is the direct result of the insurance industry's misguided investment policies. They call for greater regulation of insurance companies to smooth out the ups and downs of the insurance income cycle. Other critics contend that the problem is a national glut of lawyers who drum up business by seeking out frivolous cases to litigate. These reformers argue for the elimination of lawyers' contingency fees and placing limits on certain types of damage awards. A third group suggests that the crisis stems from gradual but revolutionary changes in the legal rules that determine liability. For these observers, the crisis has less to do with self-serving interest groups than with new ways of thinking about the law that have broadened victims' rights to compensation.

This spring, the Manhattan Institute sponsored a forum entitled “The Liability Crisis” as part of its newly initiated Project on Civil Justice Reform. The liability crisis forum was moderated by Michael Kinsley, editor of *The New Republic*. The featured speakers were: Richard Epstein, professor of law at the University of Chicago and author of *Takings* (Harvard University Press, 1985); Peter Huber, a Washington-based lawyer and scientist; and Richard Willard, director of the Justice Department's Civil Division and the Reagan Administration's Tort Policy Working Group.

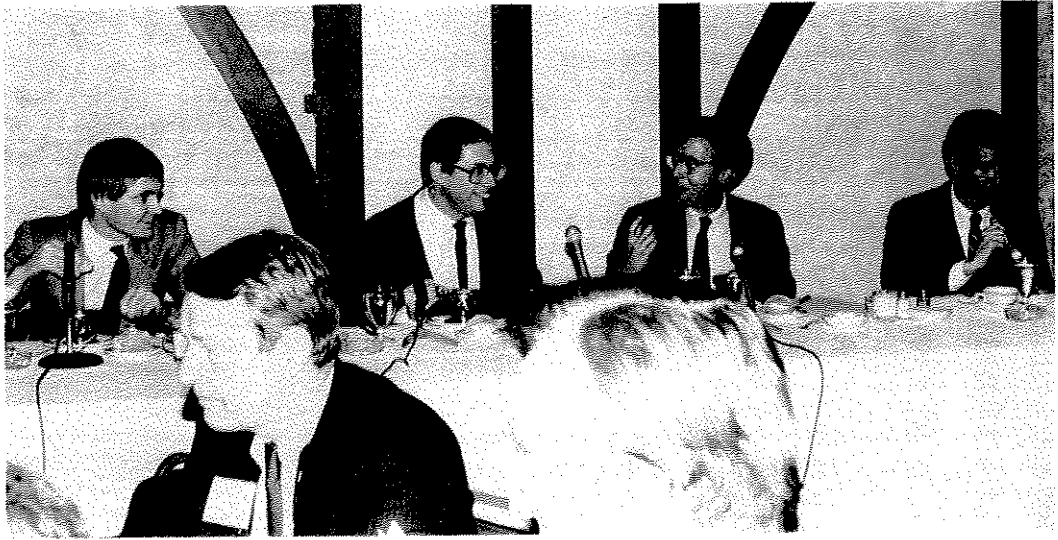
In addition, the *Report* contains two interviews: The first, with Fred Smith, President of the Competitive Enterprise Institute, discusses the liability problems raised by the federal government's Superfund law on toxic waste cleanups; the second interview with Michael Horowitz, former General Counsel of the Office of Management and Budget, discusses the politics of tort reform and its role in redistributing wealth.

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The Liability Crisis

A Manhattan Forum



Panel (l-r) Peter Huber, Richard Epstein, Michael Kinsley, Richard Willard

Michael Kinsley—Our subject today is the tort explosion. The way public policy debate works in this country, an issue usually starts out bubbling quietly on the backburner with articles written about it in scholarly journals. Then something will happen that is not a major issue in and of itself but which crystallizes the problem for a wider public. In this case, that happened a couple of months ago when New York City's Roosevelt Island tram shut down. The city couldn't get insurance for the tram even though no one had ever been hurt or severely injured. Because it happened in New York, the story appeared on the front page of *The New York Times*, which then focused national attention on the issue. Now, each day, the newspapers and television bring us new nightmare stories on the liability crisis.

We are fortunate to have three outstanding experts on this topic. We will start with Peter Huber. Peter Huber received his doctorate in mechanical engineering from MIT and taught there for several years before going to Harvard Law School where he graduated summa cum laude. Peter has written extensively on the problems of product liability including an, as yet, unpublished piece in *The New Republic* which discusses a very typical problem in this area with regard to birth control. As you may know, the last publicly available IUD has been taken off the market even though it encountered no problems with lawsuits. In fact, no new birth control devices or techniques of any kind are coming on the market because of the fear of tort liability.

Peter Huber—Of all the changes in tort law that have occurred since the 1960s, the one that interests me the most is the shift in emphasis from private to public risks. When I say public risks, I have in mind "nukes and nuisances." First, there are those rare disasters whose probability is low, but whose consequences are felt very broadly. In the

second "nuisance" category are those things like pollution and toxic torts, where the probability of exposure or release is very high but the likelihood of injury to any individual is extremely small.

Tort law up until the early 1960s dealt only with a rather narrow range of essentially private interactions which were tightly confined in space and time. The old tort law insisted that a dispute should have two sides to it. It didn't care at all for crowded courtrooms. Both the plaintiff and the defendant had to clearly distinguish themselves from the gray mass of suffering humanity and its oppressors. Under the old tort law of nuisance, for example, a plaintiff could not sue for anything in the nature of a public nuisance. If the hazard was broadly shared, it was by definition public and only a government official, not a private plaintiff, could act against it. Under the old tort law, the plaintiff had to prove that the defendant had actually caused his particular injury. If there was only a 10 or 15 percent chance that the defendant had caused it, the plaintiff couldn't sue successfully.

Times have changed dramatically in that regard. The new tort law is perfectly happy with multi-lateral, multi-party disputes of every description. It is not uncommon for class actions to embrace tens of thousands, sometimes millions of plaintiffs. Hazardous waste dumps and the DES controversy* have given rise to the so-called generic-brand litigation. Now an individual can sue a large chemical concern or pharmaceutical company and haul them

*In the 1970s, it was discovered that DES (diethylstilbestrol), a widely-prescribed morning sickness drug for pregnant women, was responsible for high incidences of cervical cancer in the daughters of women who had used the drug during their pregnancy. In many jurisdictions, the courts have allowed DES plaintiffs to sue any and all manufacturers of the drug without having to prove which company was responsible for the specific harm done.

"A system of rules which is consistent with any set of outcomes is not a system of rules at all. It is a travesty."

—Richard Epstein

into court together without being too specific about who did what. As a result, more than a few trials are now being held in auditoriums rather than in courtrooms.

The old tort law also had a firm sense of timeliness about getting into court. To get an order to enjoin my conduct, you had to prove that injury was imminent. If you wanted money damages, you had to wait even longer. You couldn't sue too late either. You typically had a few years after being injured to get your action together. After that, too bad. Today, once again, time is not what it used to be. As a plaintiff, I can get into court much earlier to enjoin allegedly risky conduct. The old requirements of imminence in hazard litigation have virtually disappeared. And if I'm suing for money rather than for an injunction, the window of opportunity has been growing even wider. Serious legal scholars at some of the nation's major law schools are proposing that exposure to *risk* rather than *harm* become a compensable injury. Others, equally solemn and serious, are talking about awarding damages for fear of accidents, even if the accident has not yet occurred. On the downstream end, damage actions are being brought much later than in the past. In more and more jurisdictions, I can sue you within a few years of discovering my injury even if the misconduct I'm claiming occurred decades earlier.

With these changes, the law has essentially discarded the two great limiting principles of the old tort law, which were that actions had to be bi-polar, very much in the nature of a private dispute, and that they had to be timely. The new tort law permits you to find plaintiffs and defendants everywhere and to deal with them en masse. It permits you to reach decades forward and backward in time in your search for things to litigate.

Has this major shift in the power of the courts and in the problems they can address accomplished a desirable social objective? Certainly, as a general compensation system, the tort law is a disaster. It has become terribly costly. For every dollar that ends up in the pockets of an injured plaintiff, \$3 to \$5 are diverted to lawyers. If a private insurance company or a charity creamed off that much of the take, it would be prosecuted for fraud. The new tort law has failed as an insurance system because of its capriciousness in whom it chooses to compensate. Insurance is supposed to take gambling out of life, not add to it.

Then there is the notion of deterrence. It's been argued that if you make corporations more responsible through an expanded definition of liability, they will make safer products. You will help to deter all sorts of risky activities. Have things worked out that way? Modern science teaches us that risk is present in some degree in everything we do. Therefore, deterrence is effective only if it can be selective—distinguishing the good, the bad, and the ugly



Richard Epstein, *University of Chicago*

Leslee Spoor

in the world of risk. The new tort law does not succeed in doing that. It knocks one bad IUD off the market but also eliminates two or three perfectly safe devices. It eliminates some bad drugs but also comes down hard on Bendectin and deters the introduction of many other therapeutic drugs. Among the hardest hit in all of this have been the makers of vaccines. Vaccines have contributed more to the improvement of public health in this country than any other pharmaceutical product with the possible exception of penicillin. Yet I'm prepared to bet that if an AIDS vaccine is developed in the next few years, no major pharmaceutical company will be willing to manufacture and distribute it without some kind of immunity from liability.

Michael Kinsley—Professor Richard Epstein is a graduate of Yale Law School. He also received a first in jurisprudence from Oxford. No one has ever accused him of being anything less than brilliant. Since 1982, he has been the James Parker Hall Professor of Law at the University of Chicago.

Richard Epstein—If I had to identify a single theme which dominates modern tort law to its great ruination, it is the replacement of fixed rules by a series of balancing tests. In contrast, if you evaluated the attitude of nineteenth-century judges, you would probably conclude that they were a profoundly anti-intellectual lot. For the most part, they argued by assertion. They had naive beliefs about freedom. They were not aware of epistemology, phenomenology, metaphysics, calculus, or anything else which might enable them to make intelligent social choices. They argued by intuition. They announced rules which they weren't prepared to defend. Yet they succeeded brilliantly in creating a viable and stable social order. Although the older judges didn't know what they were doing, they ended up doing it exceedingly well because they

operated on the basis of several modest assumptions. One is, "If you don't know what you're doing, try to do as little as possible." And two, "If you don't have perfect information about how other people should conduct their lives, then you shouldn't try to run their lives for them." This meant that tort rules had a relatively confined function. Essentially, it was the function of keeping order.

In the area of land, tort law could be summarized in the following proposition: "Keep off." If you were a doctor, the rule was: "Don't be grossly negligent." And if you were a manufacturer, to the extent that there were any guidelines at all, the rule was: "Don't create booby traps in the products that you sell to your customers." In this brief litany, I've managed to summarize a very large portion of tort law as it existed in this country up until the mid-1950s. If you actually look at some of the tort cases, though, you'll discover that my simple caricature of the tort law is not 100 percent correct. There were, indeed, many allusions to the relative importance of costs and benefits in the earlier law. But for the most part these were countered by a series of very powerful "bright line" limitations. When you engaged in a judicial balancing act, it applied only to the few odd cases that made it to trial. The run-of-the-mill cases

exceeds the social benefits. As a lawyer, you could spend thousands of dollars deposing witnesses on each and every one of these elements of liability. But it often doesn't matter because the next section of the Restatement says in effect: "If you fly an airplane and it crashes, you're responsible." The general rhetoric is forgotten and the focus is on the simple rule that if you're hit from above and you happen to be below, generally speaking you'll win. What makes this rule work is not the verbiage of the general Restatement provisions but rather two very important points which are nowhere alluded to.

One is that the defendant is always the party in possession of the instrument that caused the harm. It is the individual who is flying the plane who is responsible, not the person who made the ball-bearing used in the wing of the plane that crashed. The fellow who is in control is the one who bears the risk. He can, by and large, be confident that as his level of precautions goes up, the level of accidents will be reduced. The second point is that the fellow on the ground who is hit by the plane doesn't have much to say about the accident. You are dealing with a situation where you have a single defendant, the pilot (or airline), and a passive plaintiff. All of the risk, as far as we can tell, is best controlled

"For every dollar that ends up in the pockets of an injured plaintiff, \$3 to \$5 are diverted to lawyers. If a private insurance company or a charity creamed off that much of the take, it would be prosecuted for fraud." —Peter Huber

were generally easy.

Today, however, judges have a very utilitarian notion of decision-making. They understand that markets are imperfect, that information is expensive, that politics is corrupt, that interest groups dominate legislation, and that fact-finders don't know what they are doing. As a result, they have decided to create a set of rules which take these imperfections into account and they have made a perfect mess. Often, we have lost the balance of the tight and simple rules used by nineteenth-century judges in the more overtly utilitarian, analytical approach of current courts.

In some areas of the law, however, an effective balance has been maintained. Consider the rules which govern ultra-hazardous activities. Reading the Restatement* provisions on ultra-hazardous activities is like entering into a hall of mirrors where everything is slightly warped. You are told that liability depends upon the riskiness of the activity, whether it's in common usage, whether reasonable precautions could have avoided the risk, whether risk is inherent, and whether the cost of prevention

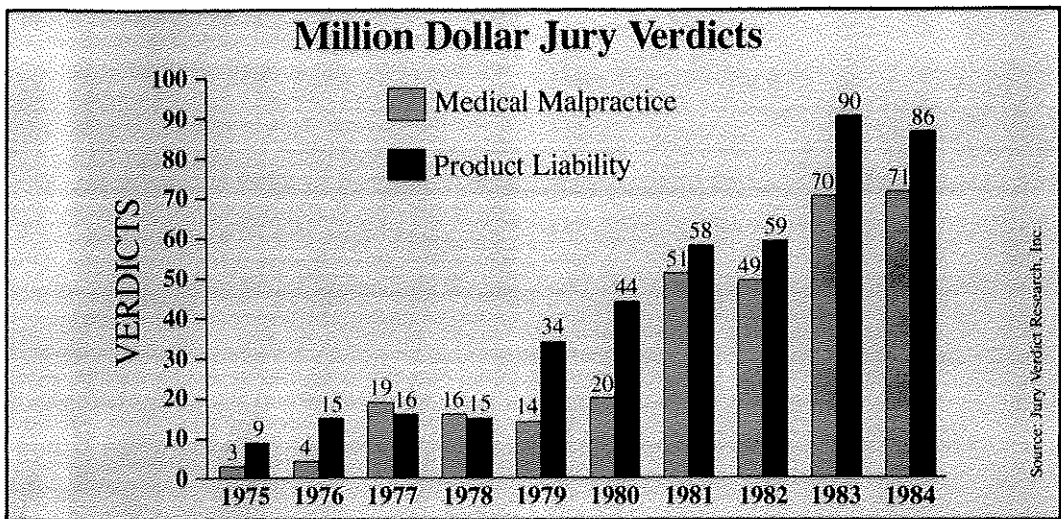
by the fellow in the air. Therefore, a rule which says that the defendant is responsible for everything is a perfectly prudent and sensible rule. All the other rhetoric is essentially noise. Airplanes will continue to fly because the airlines know that they can take precautions which will control the risk in question.

When you get into the area of product liability, it turns out that courts use a similar laundry list to the one developed for ultra-hazardous activities. The key difference is that you don't have these two natural stops. A product liability suit is one in which the defendant is not in possession of the instrument said to cause harm. The defendant, usually a manufacturer, can take any level of precaution he wants and it wouldn't necessarily lower the chances of an accident. He constantly has to worry about whether some third party modified the product, sold the product, or used the product, in an inappropriate manner. The modern law says that the manufacturer can be charged with the conduct of that person.

In product liability law, plaintiffs are not typically passive. They use machine tools, drive automobiles, imbibe drugs, and engage in all sorts of other activities that heighten the possibility of accidents. When the law drives all the liability back on

*A compendium and commentary on current tort law published by the American Law Institute.

"Jury verdicts are also very sphinx-like. They only tell the firm that it did something wrong." —Richard Epstein



the defendant, the risk structure becomes just the opposite of what it is with respect to ultra-hazardous activities. There, putting all the liability on the defendant meant responsibility and control were joined in the same individual. In product liability, responsibility and control are now frequently in separate people. For many accidents, everybody except the manufacturer is in a position to prevent the harm; yet the manufacturer is the party who is largely held responsible if an accident occurs.

Suppose that you are a manufacturer who desires to conform to all the requirements of the law. If you were required to look at the work, say, of the New Jersey Supreme Court, it would inform you that your product "should not be unreasonably dangerous." That's like telling someone that the way to win at chess is to capture the other fellow's king. Companies don't want a benign, open-ended directive. They need to know in concrete terms whether to put the warning on or keep it off.

Jury verdicts are also very sphinx-like. They only tell the firm that it did something wrong. They don't tell the firm how to correct the situation. Our current liability system clouds the signals which people would otherwise get from the market. It is a classic problem where you have more data and less information. Not only do unpredictable verdicts disrupt the incentive structure by putting out bogus information, they also make litigation impossible to handle. In a good legal system, liability should be a "yes or no" question. There should be a red light or a green light. There shouldn't be sixteen shades between red and green on which courts can calibrate various kinds of liability rules. Today, in liability cases it turns out that any result—from no liability to punitive damages—can be consistent with the evidence. That is a ridiculous phenomenon for social organization.

The following experiment performed by the Johns-Manville Company summarizes our current

legal situation. They held a mock trial, with professional plaintiffs, professional defendants, lawyers, and so forth. They then had four juries sitting side by side hear the evidence. They were asked, "On the strength of the evidence presented to you in this case, how do you come out with respect to actual damages and punitive damages?" With the same evidence and the same arguments, one jury came out with no liability for anything and another jury came out with actual liability and punitive damages. The other two juries were somewhere in between with respect to the amount. A system of rules which is consistent with any set of outcomes is not a system of rules at all. It is a travesty.

Balancing various kinds of utilitarian ends is the nature and function of law. Nobody would argue that the welfare of human beings is irrelevant. What courts must do is balance various factors until they get to a rule. Then in the very broad run of cases, that rule should be serviceable in a mechanical fashion. It won't do for courts to attempt a balancing act on a case by case basis. If they do, they sacrifice all the elements of certainty, predictability, and individual responsibility which make the utilitarian ethic go.

The great tragedy of modern judges is that they lack the moral courage or intellectual vision to say that in some cases there is a clear right or wrong answer. Instead they hedge their bets. That might be fine if courts had one case every ten years upon which they could lavish the attention that Maimonides gave to Scripture. It is not appropriate, however, in a legal universe with thousands of cases every day. What we need is a legal system which is dull, uninteresting, and expeditious. If we try to reinvent the social utilitarian calculus each time the ship of state runs through the courtroom, it will destroy the calculus and run the ship aground. **Michael Kinsley**—Our last speaker is Richard Willard. Richard Willard graduated from Emory Uni-

"Tort law is . . . becoming an off-budget program for the redistribution of wealth, administered by judges and juries without the constraints of the legislative process."

—Richard Willard

versity and received his JD from Harvard Law School. Since December, 1983, he has been Assistant Attorney General in charge of the Justice Department's civil division. Among his other activities, Mr. Willard is working on legislation to deal with some of these problems.*

Richard Willard—I would like to start by giving my views on the doctrinal changes we have witnessed in tort law. One major change is the trend toward imposing no-fault liability. This trend is premised on the theory that tort law can be used to spread risk and provide a form of social insurance to people who are injured or become ill. One of the most explicit statements of this concept was made by the New Jersey Supreme Court in the 1982 decision *Beshada v. Johns-Manville Products Corp.* which was an action brought against asbestos manufacturers. The court expressly denied the defendants an opportunity to raise a state-of-the-art defense, i.e. a defense that argued that the company was acting reasonably considering the scientific knowledge available at the time about the dangers of asbestos. The court concluded that even if the danger at the time was scientifically unknowable, the defendants were still liable for having failed to warn of an unknowable risk. As justification for its holding, the court relied heavily on the concept of risk-spreading. In the words of the court, "Manufacturers and distributors . . . can insure against liability and incorporate the cost of insurance into the price of the product."

As the tort system moves away from fault, it increasingly imposes liability on individuals and companies that have done nothing wrong. This has been accomplished in a variety of ways: by directly reducing or eliminating the fault requirement; by defining new duties that effectively create fault where no fault existed previously; and by engaging in after-the-fact analyses to find fault whenever there has been an injury. The ultimate effect of all of these techniques is to shift liability to deep-pocket defendants who have the resources to compensate plaintiffs.

A classic example of the erosion of fault-based liability is a decision by the California Supreme Court in the case of *Bigbee v. Pacific Telephone Co.* (1983). In this case, a man was injured when an allegedly intoxicated driver lost control of her car, veered off the street, and crashed into a telephone booth in which the man had been standing. A lawsuit was brought against the companies responsible for the design, location, installation, and maintenance of the telephone booth. The court found that the risk that someone might veer off the road and crash into the telephone booth was not unforeseeable as a matter of law. The court also determined



Michael Kinsley, *The New Republic*

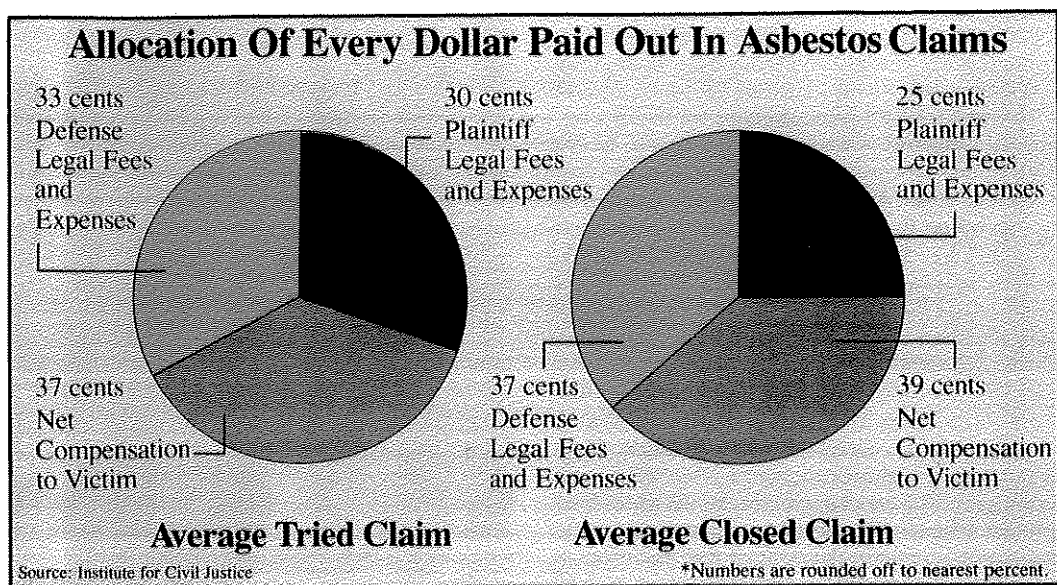
that it was of no consequence that the harm to the plaintiff came about through the negligent and reckless acts of an allegedly intoxicated driver. In a concluding footnote, Chief Justice Rose Bird stated, "there are no policy considerations which weigh against imposition of liability under the circumstances of this case," and referred specifically to "the probable availability of insurance for these types of accidents. . . ." Outrageous decisions like this one have become all too common in the past few years.

The facile assumption that expansive no-fault liability can be readily paid for by insurance companies is proving tragically false as more sources of insurance dry up. The elimination of fault as a basis for liability also removes the distinctive justification for the tort system in deterring wrongful conduct. Tort law is instead becoming an off-budget program for the redistribution of wealth, administered by judges and juries without the constraints of the legislative process.

Another doctrinal development deals with the increased use of joint and several liability to shift the cost of compensation to deep pockets. The doctrine originally was developed to handle actions involving people acting in concert. If two friends beat someone up, then the person attacked could sue one or both for the full measure of damages. Recently, the doctrine has been applied as a way of holding a defendant, who is only slightly at fault, and who has not acted jointly with the other defendants, responsible for the full measure of damages — either because the other parties responsible are not available for suit or they don't have adequate insurance coverage. This has had a particularly severe impact on municipalities. In *Sills v. the City of Los Angeles* (1979), a sixteen-year-old girl was severely injured when the drunk driver of the car in which she was

*In March, 1986, the Justice Department's Tort Policy Working Group headed by Richard Willard released its recommendations for modifying federal liability law.

"If the goal is to provide more money to people who need it, it is much cheaper to do it through private insurance or government welfare programs than through the tort system." —Richard Willard



riding ran a stop sign and was broad-sided by another motorist. The city was found 22 percent liable due to the poor visibility of the street-lane markings. The negligent driver had very little insurance coverage and was, therefore, to a large extent, judgment-proof. Unless the jury award of over \$2 million is overturned on appeal, the City of Los Angeles will have to pay the entire amount, thus becoming the unwilling insurer for the individual who committed the more egregious error.

A related development is the concept of "market-share liability," where liability is placed on an entire industry. In *Sindell v. Abbott Laboratories* (1980), the California Supreme Court determined that the plaintiffs' injuries had been caused by DES, but was unable to determine who had manufactured the particular DES. Consequently, instead of dismissing plaintiffs' claims, the court shifted the burden of proof to the individual defendants to show that their DES product had not injured the plaintiffs. As with joint liability, the result is that companies or persons may be required to pay for the wrongful acts of others.

Another problem, which often occurs in toxic tort cases, is the reliance by judges and juries on non-credible scientific and medical testimony. It has become all too common for theories and information which are well beyond the outer limits of the mainstream scientific community to be presented to juries as valid evidence. This was illustrated recently in the case *Rock v. Alfred M. Lewis, Inc.* (1986), in which a California Superior Court jury awarded a woman, who had a family history of breast cancer, \$650,000 after determining that her breast cancer was caused by a blow suffered in a freeway crash — an accident which occurred fourteen months prior to discovery of the cancer. The

use of such evidence, commonly referred to as "junk science," has resulted in findings of causation which simply cannot be justified from the standpoint of credible scientific knowledge. This has led to a deep and growing cynicism about the ability of tort law to deal with scientific and medical concepts in a principled and rational way.

If there is one common attribute in all of these developments, it is that the defendant to whom the liability has shifted almost invariably happens to be the one with the deepest pockets.

Some proponents of expanded tort liability justify the erosion of traditional legal doctrines on the grounds that victims of accidents and illnesses need to be compensated. Any legal doctrine that prevents compensation is viewed as archaic and unjust. This outlook is undoubtedly responsible for much of the expansion of tort liability that we have seen. But it is wrong for four reasons.

First, more victim compensation is not necessary. Our society has a vast need-based compensation system already in place. The system includes private and employer-financed life, health, and disability insurance. Our state and federal governments have numerous social insurance and welfare programs to provide health-care, survivors', and disability benefits. It is difficult to calculate the total amount our society spends on private and public programs of victim compensation outside the tort system, but it is in the range of hundreds of billions of dollars a year.

Second, if higher levels of victim compensation are needed, the tort system is an enormously inefficient way to achieve this goal because of the transaction costs. A Rand Corporation study of the asbestos litigation showed that two-thirds of the money paid out by the companies and their insurers

"The great tragedy of modern judges is that they lack the moral courage or intellectual vision to say that in some cases there is a clear right or wrong answer."

—Richard Epstein

went to pay for lawyers and legal expenses. Only about a third of the money actually trickled down to the victims themselves. By way of contrast, the cost to the government of administering the Social Security Disability Income program is only 4 percent. The cost of administering private first-party insurance is only about 15 percent. If the goal is to provide more money to people who need it, it is much cheaper to do it through private insurance or government welfare programs than through the tort system.

The third problem with the theory of expanded liability is that it cannot assure fairness to all victims. No matter how attenuated the doctrines of fault and causation, it will still be necessary to find a defendant with a plausible connection to the illness or the injury. There will always be a substantial number of illnesses and injuries that are acts of God, totally self-inflicted or entirely attributable to parties that are uninsured or insolvent. There is no way that tort liability can ever be expanded enough to assure every victim a recovery.

This raises the question, "Why is it fair that some victims get a recovery and some do not?" If I am killed by lightning, my family will only receive my private insurance and Social Security benefits. If I am run over by a negligent truck driver, however, they will also receive hundreds of thousands of extra dollars. The reason this disparity is fair has to do with the role that assigning fault plays in deterring negligent conduct. The incentive created by the award of liability is that truck drivers will tend to drive more safely. By way of contrast, expansive tort liability distorts that incentive.

Some proponents of expanded victim compensation recognize that the tort system does not work very well. They propose supplementing the tort system with an alternative claims-compensation system. It would involve a trade-off between the standard for determining fault and the level of benefits provided. Although there would be a more limited measure of recovery for such things as non-economic damages, a claimant would not have to show as much proof of fault. There are three problems with this alternative claims-compensation program.

First, this program does not solve the perverse incentive effects of no-fault tort liability. To the extent that it further attenuates fault or causation, it makes matters even worse.

Second, even though such a program would have lower transaction costs than the current tort system, it would still cost more than first-party private insurance or government welfare programs because of the lawyers, due process, and other procedural trappings that would be required.

Finally, the total cost of an alternative claims compensation program could be enormous, even though damage levels are limited. If it is a non-exclusive remedy, then all of the current big-dollar



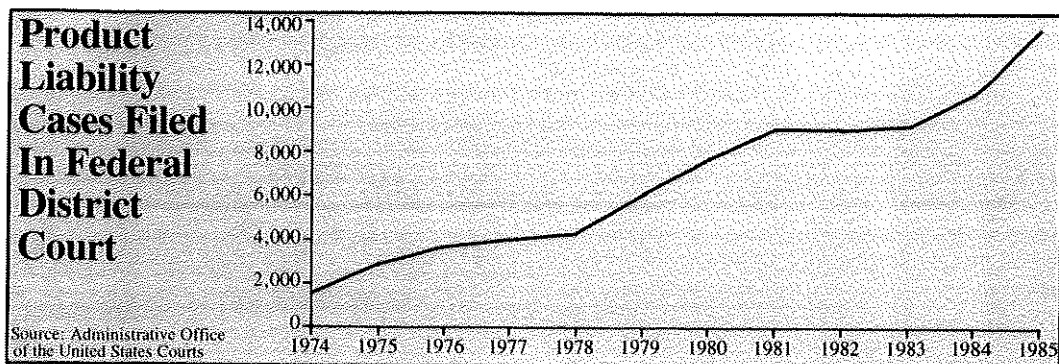
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cases will stay in the tort system and a large class of new cases where no money is now being paid will then have to be compensated. Even if the alternative system is made the exclusive remedy, it will still probably cost more than the present system. The Consumer Federation of America estimates that there are 30 million product-related injuries every year, yet there are only 70,000 product liability lawsuits. If we further erode the doctrines of fault in causation to allow this vast expansion of the number of people who receive compensation, even at a more limited level, the ultimate cost is likely to far exceed that of the current tort system. It is clear that tort reform is necessary and that it should be directed towards limiting the expansive theories of liability that have been developed in recent years. Returning tort law to its traditional boundaries would have a substantial effect in alleviating the liability crisis our society now faces.

Questioner—We've recently heard that the insurance industry has conspired not to write policies in order that a tort reform program might be implemented. I'm wondering if the Justice Department has investigated the insurance industry's conspiracy to lose money. Second, isn't it accurate to say that Superfund is really the ultimate extreme of tort? Shouldn't reform of the tort system include at least some change of the Superfund?

Richard Epstein—The implicit assumption about insurance markets is that they always clear no matter what the underlying risk happens to be. In order for insurance to go forward, however, certain standard contracting problems need to be overcome. First, there is moral hazard which is the notion that after a firm issues insurance, the probability of an accident will be greater than it was before. Second, there is adverse selection which is the concept that bad risks are more likely to come forward to obtain insurance because they can beat the premium. The last factor is non-diversifiability of underlying risk.

"For many accidents, everybody except the manufacturer is in a position to prevent the harm; yet the manufacturer is the party who is largely held responsible if an accident occurs." —Richard Epstein



The most difficult perils that the insurance industry faces are common mode perils. A change in liability rules affects all accounts of insurance companies in the same way. Faced with such risks, better diversification often results in non-insurance. Thus, there is a perfectly straightforward explanation as to why insurance markets break down under these circumstances.

With respect to the Superfund, its liability provisions are a disgrace, and the government ought to be told so. It is difficult to fashion an effective system to control liability by holding people liable for things which other people have done. The right rule for Superfund would be to go back to a "privity" doctrine which, in effect, says that only the people in charge of the dump site have to bear the tort liability. Joint and several liability down the chain of distribution creates perverse incentives and administrative nightmares.

Questioner—Assume that an insurance company underwrote asbestos risk in 1951 for the Johns-Manville Company. We go downstream twenty years and science is now able to identify carcinogenics which were unknown at the time the insurance was written. The premium, of course, was based on identifying only the risks seen as possible at that time. What would happen if the insurance industry went to the kind of contracts which said, in essence, we are insuring you against only those risks which are currently scientifically identifiable?

Richard Willard—I don't agree that the hazards of asbestos were unknown in 1951. As a factual matter, I believe the asbestos industry was aware of the hazards by 1951. The asbestos case is not a situation where liability is being imposed retroactively because of advances in science. I do agree, though, as a general principle, that it is counter-productive to impose liability retroactively for conduct that was reasonable at the time.

Richard Epstein—I agree with Richard on that part, but there is another element which has to be addressed. In 1951, it was perfectly clear that if a manufacturer supplied products to an employer, all the risks associated with that product, known or unknown, were funnelled through the workers' compensation system. Before 1960, there were virtu-

ally no cases where a plaintiff could jump over the employer and get back to the original manufacturer. Product liability litigation was minimal because cumulative trauma cases that resulted from workplace activities, in practice, were never part of the tort system. Even as late as 1972, the clear understanding was that manufacturers were not—and should not be—the targets of workplace liability cases. That is, in fact, the appropriate position to take in most cases. While manufacturers may have had some information about asbestos, it was a generic product. Unless someone can demonstrate that they suppressed private information, the scientific studies outlining the dangers of asbestos were available to everyone else. The correct response is to put the liability on the employer because he can control such things as ventilation, exposure, and exertion levels, which are critical in determining the level of harm in the workplace.

Michael Kinsley—Are you saying that an employee in 1951 had as much access to knowledge of the dangers of asbestos as the manufacturer?

Richard Epstein—I didn't say the *employee*, I said the *employer*! Not only that, I said he had *superior* knowledge. The information the manufacturer had was generic—asbestos can kill or not kill. What actually determined the incidence of injury, i.e. the size of the fiber, the rate of ventilation, and so forth, were factors more readily controllable by the employer.

Questioner—If an insurance company entered into a contract where they were only responsible for risks scientifically ascertainable at the time the contract was signed, would it stand up in the courts?

Richard Willard—The approach of courts to contract issues has exacerbated the insurance problem. The courts, by and large, are unrealistic in the way they read insurance contracts. They use a variety of legal doctrines which add up to one bottom line: the insurance company loses. They argue that insurance contracts should be construed in order to provide coverage, not to deny it. Insurance contracts are often construed against the insurance company because it is presumed that the company was responsible for the drafting of the agreement. That is not always true in reinsurance, but that is the way

"On an intellectual level, most people . . . simply do not believe that standard assumptions about rational behavior work."

—Richard Epstein

the courts approach it. We have a whole series of legal doctrines which have led to the rather absurd point, that "sudden and accidental" pollution coverage issued by insurance companies has been interpreted by the courts as including gradual and deliberate pollution—a linguistic feat worthy of Lewis Carroll.

Questioner—Professor Epstein is correct when he suggested earlier that we don't want to dictate how other people live if we don't have good information. But there are some areas where we can make good guesses. For many people the increased liability activity has brought a certain amount of comfort.

Richard Epstein—How?

Questioner—There are those little kickback guards on chainsaws. There are all sorts of products that have been made safer in a variety of ways. Given your rather hard and firm rules about this, can you think of other ways in which we might promote more safeguards?

Richard Epstein—That question has got it the wrong way. You know there are safeguards on some of these chainsaws. You don't know if they are

lose 100,000 people in an epidemic, people may start to reconsider the one life lost through injecting a vaccine against the 100,000 lives lost for want of its development.

On an intellectual level, most people, and most legislatures, simply do not believe that standard market assumptions about rational behavior work. Instead, they work in the crazy world of judges where all demand curves are perfectly inelastic and all lawsuits are perfectly costless.

Questioner—It strikes me that if the insurance industry could price its product, it would make the problem inherently self-limiting. As the true cost of expanded victim compensation is passed back to the public, you would begin to get pressure for reforms.

Richard Epstein—I think that's incorrect. The industry will only price the risk with respect to those products that remain in the market.

Peter Huber—Markets can clear if you have a reasonably static environment and people know it is going to remain that way. But at the moment, insurance companies aren't saying "We'll give you toxic insurance at some price." They are saying "We

"What might shift opinion is a great public tragedy. I don't want one but vaccines are a perfect illustration of what could go wrong. If you lose 100,000 people in an epidemic, people may start to reconsider the one life lost through injecting a vaccine against the 100,000 lives lost for want of its development."

—Richard Epstein

safety effective. You do know that they are liability-driven. Kip Viscusi has done studies on safety caps for medicines, for instance, and found them to be quite hazardous. People who can't open the caps because of arthritic fingers take the pills out and place them in unmarked bottles. When they need an upper, they take a downer, and they go sideways.

We don't need government to encourage consumer safety. If you look at the studies, there is simply no correlation between safety and our expanded system of liability. There are many ways to improve safety, but they are voluntary. If people don't know how to buy medical services, let them go through a Health Maintenance Organization (HMO). Information is a good. It's costly, and the right way to handle it is through responsible intermediaries. Our current law frustrates those intermediaries by exposing them to open-ended liability.

Questioner—How can we reform the system?

Richard Epstein—I'm a pessimist with respect to finding winning coalitions at the present time. Torts is big business. What might shift opinion is a great public tragedy. I don't want one but vaccines are a perfect illustration of what could go wrong. If you

don't want to touch it." If I were their legal counsel, I'd support that stance. They're crazy if they write any toxic insurance.

Richard Epstein—Even if the market is in equilibrium, it may not be optimal for society. Markets clearing under regulation can be as perverse as those which don't.

Questioner—I'm told that there has been a recent change with regard to the courts that preside over patent decisions. We now have a mini-Supreme Court in patent law where manufacturers win two-thirds of the patent cases. Would you comment on this?

Richard Willard—All patent appeals have been shifted from the regional circuits, which had a distinctly mixed record on patent law, to the Court of Appeals for the Federal Circuit. The number of patents which have been sustained by that court is a higher ratio than previously were sustained by some of the courts of appeal.

Michael Kinsley—Why wouldn't this be a solution to Professor Epstein's problem of judges who don't know what they're doing?

Richard Epstein—Because you don't have any di-

(Continued on back cover)

Rethinking Superfund

An Interview With Fred Smith

Fred Smith is the president and founder of the Competitive Enterprise Institute, a Washington-based think tank. He formerly served as a policy analyst for the Environmental Protection Agency.

Manhattan Report—What are the origins of Superfund?

Fred Smith—The Superfund law—the Comprehensive Environmental Response, Compensation, and Liability Act—was passed by Congress in 1980 in the closing days of the Carter Administration. Superfund was to clean up hazardous waste sites that had been abandoned or for which the companies or individuals responsible for the dumping couldn't be identified.

Since then, the role of Superfund has been greatly expanded. It now covers virtually *all* hazardous waste disposal sites. The original act established a \$1.6 billion fund for the cleanup which came out of general federal revenues as well as special taxes imposed on the oil and chemical industries. There is a big push now to increase the spending pot. The House of Representatives has voted \$10 billion in additional funds.

What is even more significant for companies that deal with hazardous waste, however, are the provisions in the Superfund act which allow the government to sue individuals and corporations who are deemed responsible for the dumping. They can be forced to pay directly for the cleanup costs.

MR—Who is liable under those provisions?

Smith—Virtually anyone can be held liable. The rules under Superfund reach back into time and space so that anyone with even the remotest economic connection to the hazardous site can be forced to pay for the cleanup. You can be held liable for the cleanup if you currently own or operate a waste site, if you did so in the past, or if you transported waste materials to the site. Even manufacturers who arranged for their waste products to be transported by disposal companies which they assumed were reputable can be held liable. This leads to all sorts of distorted notions of responsibility. In one case, *U.S. v. Maryland Bank*, the Justice Department is trying to recover cleanup costs from a bank that held title to a waste site from a foreclosure proceeding.

What compounds the problem is the notion of "joint and several liability" where a person or company connected with the waste site in a minimal way can be forced to pay the entire cleanup cost. In *U.S. v. A&F Materials*, a middleman who merely arranged for the sale of the hazardous material was ordered by the court to help pay the cleanup costs along with the actual polluters.

MR—How does the government decide who pays?

Smith—It's purely a discretionary decision. They generally look for the deepest pockets they can



Fred Smith, Competitive Enterprise Institute

find. It is much easier for the courts to determine wealth than it is to determine guilt. In recent hearings on Superfund, an EPA (Environmental Protection Agency) official as much as admitted that the government defines its standards on liability based on what factors make it easier for it to organize its case.

Superfund allows EPA to assign responsibility in a highly irresponsible way. Determining the party actually responsible is difficult, especially for the abandoned sites that are supposedly the foci of Superfund. EPA "solves" this problem by suing the usual corporate suspects and shifting to them the more difficult task of determining—if they can—the facts of the case. The inequities of this approach are astounding. Yet, they make it very easy for the government to "win." The government simply picks a deep pocket and then lets all the other parties involved scramble after each other with lawsuits and counter-lawsuits. The rules are designed to make it easy for the government to win cases, not to apportion blame fairly.

This kind of policy is counterproductive from the standpoint of environmental quality as well. If the law reaches out to grab people who feel they have clearly done nothing wrong, those people tend to resist the punishment. Lengthy litigation delays the actual cleanup of many potentially hazardous sites. Some experts believe the litigation costs of certain cases actually exceed the total cleanup costs. Attorney fees alone may exceed \$5 billion for the 1,800 sites on the EPA's priority list—over one-third of the direct cleanup costs. Moreover, the "deep pockets" approach of the Superfund law discourages the operators of waste sites from acting in a

"It is much easier for the courts to determine wealth than it is to determine guilt."—Fred Smith

responsible fashion. If they know that the government will tend to go after the giant chemical companies that can afford to pay, why should they practice care in the handling of hazardous wastes?

MR—Granted, it does seem unfair to make some people pay for the past negligence of others. Still from the standpoint of future liability, won't large manufacturers be more responsible in who they choose to transport waste for them or where they dump it if they can also be held liable?

Smith—The problem is that the most effective way for the manufacturer to control the other parties is to contractually channel liability, which isn't allowed. Dow Chemical may sign a contract with a disposal site indicating that the operator of the site will be held liable for any deviations it makes from specified safety procedures, but the courts may not honor it. They might argue that "you should have known the guy was a crook" or "you should have foreseen that someone using the same dump as you was depositing harmful materials." Under current liability rules, it's impossible to escape responsibility for other people's actions—even when you have no control over their actions.

MR—If private companies are sued for Superfund cleanups, can't they shift the expense to their insurance companies?

Smith—They are certainly trying. There was a case in Jackson Township, New Jersey where the town was sued by local residents who claimed that the municipal dump was contaminating the water supply. The insurance company that wrote the town's general liability policy, which excluded coverage for pollution unless the release was "sudden and accidental," thought that it was not financially responsible for a contamination that occurred over many years—in this case, twelve years. The court, however, ruled that each contaminated well constituted a separate "occurrence" and found coverage under the policy. Rather than insuring \$1 million of risk, the insurance company found itself responsible for insuring up to \$160 million in potential damages. That shook the insurance industry to its roots and led to a dramatic pullout from the reinsurance market. Although the Jackson Township decision was moderated in subsequent appeals, it convinced many insurance companies that there was no way of guaranteeing certainty in the area of environmental risk.

MR—The notion of liability seems fairly broad. What about the definition of "hazardous waste" itself?

Smith—That's an equally broad area. It includes everything that is flammable like charcoal lighter fluid, reactive like Clorox or ammonia, corrosive like Drano, or toxic like roach poison. The EPA really has no coherent standards concerning what concentrations of these materials constitute a health hazard. Since almost every home contains these

types of substances, one can imagine a situation where if a house was abandoned or burned down it could be declared a hazardous waste site.

MR—If that's the case, how does the EPA decide what sites to clean up?

Smith—The EPA works with the various state agencies in determining sites, but it's essentially a giant "pork barrel" public works operation. If you were to assign a political science class to come up with the perfect public works program, one which had zero political opposition and which wasted unlimited amounts of money, it would come up with the Superfund. Superfund is the "black hole" of public works programs. Of course, Superfund undoubtedly achieves some environmental benefits—it's not easy for even an agency like EPA to waste every penny of the billions being spent. However, Superfund contains almost no incentives to consider costs or benefits.

Most federal programs involve some local cost-sharing. With Superfund the local cost is zero. The federal government pays 90 percent of the cleanup and the state picks up the rest of the tab. From the perspective of defusing political opposition, again, Superfund is pretty much the ideal program. Ordinarily with the location of a prison, or a disposal plant, or even a parking garage, there is usually some local opposition. Superfund, however, promises to clean up your local dump and move it somewhere else.

MR—Where does it go?

Smith—That, of course, is the problem. Everyone wants it out of their own backyard but where do you put it? You end up with this "move-a-dump-a-day" plan that goes nowhere. I can envision by the year 2000 a million waste haulers traveling day and night around the country with nowhere to park, which is undoubtedly the most hazardous way to deal with the problem.

It's ironic that the overriding goal of Superfund is to improve public health when the first step in the cleanup is to uncover the waste. You'd wonder about a public health program where the first step was to dig up the town graveyard, which is exactly what waste sites are—chemical graveyards. By exposing these materials to both wind and water flows, you may well create a greater hazard than before.

MR—Superfund may not be the appropriate solution to the hazardous waste problem, but isn't some government action required to deal with the abuse of private companies?

Smith—The story that led people to endorse Superfund was the Love Canal incident in upstate New York. The way the story is usually told, a chemical company, totally disregarding public health concerns, indiscriminately dumped chemicals in the local area, contaminating the water supply, leading to health problems, and even death, among mem-

"Superfund is the 'black hole' of public works programs."
—Fred Smith



Wide World Photos

Toxic Waste Cleanup At Love Canal

bers of the local community.

The facts are actually quite different. Back in the 1940s, the Hooker Chemical Company purchased the Love Canal site as a place to dump their hazardous wastes. The canal was a heavily-lined clay ditch. After dumping their wastes, the Hooker company sealed off the ditch with a heavy clay coating to protect local residents from any dangerous exposure to the materials. They weren't environmentalists. They were just individuals worried about the future liability of their company.

It was some years later that the local school board approached the Hooker company about purchasing the site for the construction of a school. Hooker demurred on the grounds that the site was dangerous. The school board insisted, threatening to seize the land by eminent domain.

The company finally donated the site to the school board with the proviso that the land never be disturbed below the surface in the area of the toxic deposits. The school board ignored repeated warnings from the Hooker company about developing the property. In the mid-1960s, the land was sold to a developer, and streets, sewers, and electrical lines were dug.

The real story at Love Canal is that private companies have strong incentives to deal responsibly with hazardous waste as long as there are sensible rules regarding liability. On the other hand, today Superfund policy makes *everyone* responsible for toxic waste, and thus in the end, makes *no one* responsible.

MR—What other alternatives do we have?

Smith—One way would be to try to develop a better system of property rights for underground water tables. The major health concern with hazardous wastes is that they seep into and contaminate under-

ground water supplies (aquifers). There are so many users of such aquifers that no one has an effective ownership incentive to protect their future value.

The petroleum industry has handled the same problem in the case of underground oil with a scheme called "unitization." With unitization, all of the users of the oil transfer their management rights to a single party, within an association, much as in an apartment condominium. Then that single company regulates the extractions and revenues for all of the users.

Another approach would be to encourage greater regulation by the insurance industry. In the nineteenth century, steam boilers were extremely unsafe until the insurance industry stepped in to implement safety standards and inspections. They could do the same with toxic wastes if the courts were willing to enforce insurance contracts that held companies liable to insurers for disregarding safety standards. The insurance companies, themselves, should not be held liable for damages incurred by companies that disregard the safety requirements written into their insurance contracts.

The problem here, though, is not merely liability. The insurance industry is one of the most heavily regulated in the country. Any time that insurance companies attempt to institute new policies to adapt to changing market conditions, they are forced to pay a price. State regulations usually insist that they take on a certain number of undesirable clients. Assigned risk pools in auto insurance are a well-known example. Those kinds of trade-offs just won't do. What we need is a deregulated, competitive insurance industry if we are going to develop innovative ways of handling the risks that toxic wastes pose. □

The Politics of Tort Reform

An Interview with Michael Horowitz

Michael Horowitz is a partner in the Washington law firm of Dickstein, Shapiro, and Morin. He served at the White House as General Counsel of the Office of Management and Budget from 1981 to 1985. He also served as Chairman of the Administration's Toxic Torts Compensation Working Group.



Manhattan Report—Why has the liability crisis emerged now?

Michael Horowitz—The crisis in tort liability is really the third wave of the politics of redistribution. In the 1960s, the political system reallocated resources through vast on-budget transfer payment programs such as Medicaid, disability, and food stamps. In the 1970s, the focus shifted to the regulatory agencies like EPA or OSHA, which had the discretionary power to impose massive effective taxes on regulated parties, and regularly did so. In the Reagan era, however, those avenues have become political deadends. Tort law, previously a backwater area of private law, has now become the principal means for reallocating resources away from active economic producers to passive—often culpable—“victims” of the economic system.

You can't get five votes in Congress, today, for national health insurance. Nor can you get any support for an EPA or OSHA ban on smoking in the workplace. But if you tinker just enough with tort law doctrines and make cigarette manufacturers liable for all the cancer found in smokers, you can achieve—at an extraordinary and largely undemocratic cost—something of the same result.

MR—If it's time to back off from this kind of approach, what do you see as an agenda for reform?

Horowitz—Obviously political reform is a high priority. On a more fundamental level, though, the liability crisis reflects a philosophy of how we should go about solving social problems. It reflects the notion that social problems are better dealt with by allocating resources than by

enforcing values.

When I was at the Office of Management and Budget (OMB), the litmus test for measuring your concern about educating children was the amount of resources you were willing to allocate to the Education Department budget. Discussions about homework, discipline, or other factors related to academic achievement and the excellence of schools were not only ignored but were seen as an intrusion on the government's higher moral function as a disperser of funds to interest groups.

The same kind of mind-set became pervasive in the area of tort law. The courts were no longer interested in enforcing rules of conduct implicit in a fault-based system of tort law. They adopted, instead, an alleged “insurance model” for tort law to effect deep-pocket transfer payments to injured parties.

MR—These changes have taken place in fifty separate systems of state courts. If we are going to reverse some of these trends, don't we need a concentrated effort at the federal level?

Horowitz—It depends on what area of tort reform you're looking at.

In the area of product liability, the need for federal intervention is both acute and appropriate. If a product is made in one state and sold in the other forty-nine states, there is no way that a legislature or court can protect a local manufacturer from liability lawsuits. The costs and benefits of tort law are not fairly distributed across state lines.

In that kind of interstate commerce situation, federal action is required. That doesn't mean that we need national,

uniform product liability legislation, only that we place certain limits on the ability of state courts to expand liability in a fashion which unduly burdens interstate commerce.

In the area of professional malpractice, state reform is more appropriate. In that type of situation, the interests of the professionals residing within the state and the interests of their injured plaintiffs can be properly balanced. One may not care for particular state outcomes, but an institutional process is in place to allow affected parties to work matters out.

MR—In light of that analysis, how do you view the Reagan Administration's proposals for reform?

Horowitz—They make sense—both as legislative vehicles in need of adoption and as instruments to shift the terms of national debate regarding the role, structure, and direction of tort law. They limit product liability without imposing national standards. Moreover, they avoid the kind of political logrolling that was the fate of prior product liability bills. The idea used to be that if you took a right of recovery away in the tort area, you had to replace it with some type of costly workers' compensation system. The Administration's bill does not do that. It is a serious attempt, not to supplant common law, but rather to restore it to its traditional grounding in the notion that people should be held responsible for, and only for, the consequences of their “own” negligent actions. A return to traditional tort law doctrine will help to restore efficiency, predictability, and responsible conduct to our nation's economic system. □

The Liability Crisis

(Continued from page 11)

versification of risk. If you have one court and it's truly awful in one direction, it would be a disaster. You could lengthen patents and create cartels. Drugs that are already on the market would remain and their patents would be extended. New drugs would not emerge because the liability risk for the introduction of a new product would be too great. You could have a government-organized cartel under the name of patent reform.

Peter Huber—I think the thrust of the question was that we need some sort of expert court. I'm a bit skeptical. We already have experts who evaluate risk. They work in the FDA (Food and Drug Administration) and the EPA (Environmental Protection Agency). Unfortunately, under current law, compliance with the regulatory requirements of EPA or FDA counts for zero when you're in court. It is merely considered evidence. We now have several cases where people have placed warnings on products in exact compliance with government standards, and they still have been held liable for mislabeling, not only for ordinary damages but for punitive damages as well. We don't need an expert court. We need to use more effectively the regulatory experts we already have.

Questioner—Does Assistant Attorney-General Willard believe there is a federal solution to this problem?

Richard Willard—Tort law is almost exclusively judge-made state law. Most tort reform must, therefore, emerge at the state level. There is a legitimate federal role for products that are made and sold in interstate commerce — federal products liability law. But I do not favor federalizing all tort law.

Richard Epstein—There is another complication. The general position of the courts on economic matters has been that there is no piece of legislation so profane that they will strike it down. Tort, however, seems to be an area where they are likely to reverse that position. There is a risk that tort reform

bills will be struck down by courts who wish to defend the departures from traditional common law that they have just created.

Peter Huber—That may be true in the state courts, but the federal courts are now quite unambiguous. The challenge to California's malpractice law reform was dismissed for want of a substantial federal question. That's the biggest put-down you can get from a court when you have an appeal.

Questioner—What are abuses of the tort system costing the insurance industry?

Richard Epstein—The cost is not simply the amount of damages a defendant ultimately ends up paying, it is also the *variance* in damages one may have to pay in any given case. Consider a case where the feasible range for damages goes from zero to \$100,000, and the defendant ends up paying \$100,000. The defendant will litigate that case quite differently from one where the range goes from zero to \$20 million, even if he still ends up only paying \$100,000. Take the Agent Orange cases where the settlement was ultimately \$180 million. The fact that the companies were staring at a potential \$30 billion liability meant that their defense work took on a totally different form than if the upper bound had been fixed at \$250 million.

Richard Willard—The jury verdict is not the entire picture. People settle cases out of court based on their expectation about what will happen. When jury awards go up, that portends increases throughout the system. A good indicator of total settlement costs was provided recently by Mayor Koch in his testimony before the Governor's Advisory Commission. In 1977, New York City, which is a self-insurer, paid out \$24 million in settlements for personal injury cases. By 1985, the figure had gone up to \$114 million. That is almost a 400 percent increase. Since the city is self-insured, that can hardly be a conspiracy by the insurance industry. There is no doubt that this problem involves a large and rising cost to society. □

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