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Liability Reform and the Economy

Reform of the liability system remains one of the business community's top priorities. Economists, and legal theorists as well, worry about the distortions in the economy and the justice system introduced by a runaway tort system. In recent years, efforts to rein in the excesses have met with modest success, including, in 1995, national legislation to limit abusive securities-fraud suits.

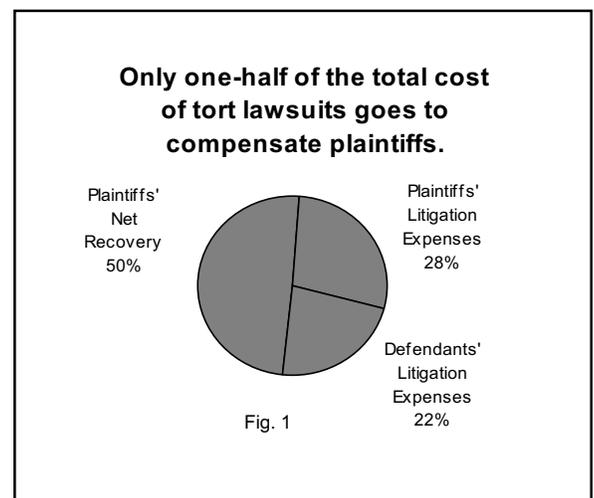
In Washington state a coalition of government and business tort reform advocates proposed a seven-part comprehensive proposal attempting to address court decisions and associated developments that have weakened the state's major 1986 tort reform act. The theme undergirding their effort was a reduction in lawsuit abuse. Their proposed legislation did not pass either chamber.

The legal system is the integral infrastructure of the modern economy, defining property rights, enforcing contracts, and providing remedies for those who have been injured by others. Since the 1960s, the law of torts, which defines the remedies for injuries, has evolved in ways that create major impediments to economic activity. As this *Policy Brief* makes clear, reform is appropriate.

Increasingly the courts accepted the proposition that the liability system should be a means of social insurance. The pockets of businesses (and governments also) are often convenient and deep. Individuals who have suffered harm seek compensation—and the traditional questions of fault should not stand in their way, or so the architects of the new tort law believe. The new thinking imposes a substantial cost on us all.

One study estimates that the liability system absorbed \$161 billion in 1995, 2.3 percent of the nation's Gross Domestic Product (GDP). Liability premiums reportedly represent 30 percent of the cost of a stepladder and 95 percent of that for children's vaccines. A study of prescription drugs finds that the American liability system raises prices for a sample of 119 drugs by 25 percent over Canadian prices.

Much of these outlays go not to compensate the injured but rather to administer the system. As Figure 1 shows, a RAND Corporation study estimates that victims netted as compensation only one half of the expenditures on tort lawsuits. Twenty-eight percent of the cost was absorbed in plaintiff's litigation expenses; 22 percent in defendant expenses.





Three Wrong Notions Created New Rights

Professor George Priest of Yale University argues that the shift in the tort system is the product of a broad reconceptualization of the relationships between individuals and business enterprises which gained academic acceptance in the 1950s. The new view rests on three questionable presuppositions:

- Modern business organizations have vast bargaining power over individuals. Thus the process of contracting between individuals and these organizations is inherently coercive and unfair. Courts should not enforce unfair contracts that limit the liability of corporations to individuals.
- These large-scale organizations can cheaply spread risks across customers. Individuals, in contrast, find it difficult or impossible to buy insurance at fair prices for many of the risks of modern life. As a consequence, public welfare is enhanced when the liability system forces business organizations to provide insurance for their customers and employees.
- These business organizations are more readily able to control risks than are individual consumers. Thus when the legal system places liability on the organizations it creates the appropriate incentive to minimize the full social costs of risk.

These presuppositions lead to the doctrine of enterprise liability: Business enterprises should be strictly liable for all of the risks in the production and consumption of their products. This doctrine has been most fully developed in the field of product liability.

Prior to the 1960s cases involving the injury in the use of manufactured goods were controlled for the most part by the law of contracts. Courts would look to the agreement between the buyer and seller to determine how the costs of injury would be born. In some instances, notably foods, the courts applied a negligence rule. The manufacturer would be held responsible for the injury if it was determined he failed to exercise due care in making the product.

Under the new theory, manufacturers became strictly liable for harm suffered by the users of their products as long as it was the result of some defect in the product, and without regard to whether the defect was the result of any negligence on the manufacturer's part. Failure to provide adequate warnings of the risks of a product could be a defect in itself. In some cases the courts have held manufacturers liable for failure to warn of risks that were unknown to science at the time of manufacture. The defense of contributory negligence on the user's part was restricted, and in some jurisdictions it was not available at all. Thus manufacturers were forced to compensate for injuries that resulted from the misuse of their products by consumers.

Mass Class Actions and Entrepreneurial Attorneys

As the courts elaborated the doctrine of enterprise liability, the number of successful mass class action lawsuits exploded. By aggregating a number of claims into a single lawsuit the class action have the potential to achieve significant cost savings for both plaintiffs and defendants. However, as researchers at RAND's Institute of Civil Justice have observed, "the civil justice system has not responded well to the challenge of handling mass torts."

Much of the concern focuses on the entrepreneurial attorneys that are active in this area. In these class actions, typically, no single plaintiff is in a position to control the actions of the attorney. In such a situation the danger from conflicts of interest between the attorney and his clients is particularly high. Some analysts, particularly Professor John Coffee of Columbia University, believe that attorneys often negotiate settlements that are in their own best interest rather than in the interest of their clients.



A second area of concern is the tremendous leverage that accrues to the plaintiffs in mass class action suits. In many of these the worst case scenario for defendants should the case go to a jury will be a huge loss. Defendants averse to risk may choose to settle seemingly winnable cases to avoid the chance of big loss. As the RAND researchers note, “even from the beginning, defendants may view litigation as ‘a bet the company proposition’ and shy away from trials.”

Professor Priest notes that “commentators unanimously concede that virtually every mass tort class action that has been successfully certified has been settled out of court. . . . We have recently observed mass tort actions at enormous sums of money where there appears to be no substantive basis for defendant liability.”

Congress Acts to Reform the System

Tort reform was one of the planks in the “Contract with America” and has been high on Congressional leadership’s agenda since 1995. But achieving agreement on legislation for broad reform has proved difficult. Two years ago Congress passed specific legislation regarding class action shareholder lawsuits: the Private Securities Litigation Reform Act of 1995. This bill provides an illuminating example of the possibilities and difficulties of civil litigation reform.

The legislation addressed the rapid increase in the number of suits against companies whose stock prices had fallen following the release disappointing earnings reports. Attorneys who specialized in these “strike lawsuits” would look for situations where the fall in earnings was at variance with earlier positive management projections and then sue alleging a fraud against shareholders.

The strike suits were abusive, experts agreed. The optimistic projections were often made in good faith with no intent to mislead investors. Even in such cases, however, companies often choose to settle out of court rather than to bear the expense of a court case and the risks of a jury trial. Young firms on the cutting edge of technology are particularly risky investments and the prices of their shares can fluctuate wildly on the stock market. These strike suits were a particular problem for younger high tech firms. Thus, not surprisingly, the electronics and software industries were strong supporters of reform.

The reform act included a number of features. For example, the target company’s largest investor would be the lead plaintiff in any class action. This was intended to limit the ability of the plaintiff lawyers to control the case. Judges were granted the power to penalize lawyers and plaintiffs who brought frivolous suits.

The law established a “safe harbor” from which companies could issue statements without fear of subsequent suit for fraud. To be protected, the statements had to be “forward looking” and had to be accompanied by “meaningful cautionary statements.”

Bipartisan Support for Reform; Veto Overridden

The bill passed both houses of Congress with strong bipartisan majorities. President Clinton vetoed the measure, and both houses voted to override the veto. This was the first bill to be enacted over his veto.

The law has been successful in reducing the number of class action cases filed in the federal courts. However, as Stanford University Law professors Joseph Grundfest and Michael Perino have documented, this has been accompanied by a significant increase in the number of suits filed in state courts, under state laws. In some ways, the situation is worse than it was before the enactment of the federal laws. The companies that are the victims of the strike suits now find themselves facing parallel suits in federal and state courts.



Closing Loopholes

New legislation sponsored by Representatives Rick White (R-WA) and Anna Eshoo (D-CA) has been introduced in Congress. Their bill would prevent plaintiffs from using the state courts to avoid the reforms of the 1995 Act. In a case brought in state court, defense attorneys would be able to have the case removed to federal court. While closing the state court loophole would seem to be uncontroversial, indications are that it will be a difficult fight.

Here in Washington, critics of the current system will again seek comprehensive reform in the 1998 legislative session. While the goals remain unchanged, it's likely the specific proposal to the legislature will be modified, recognizing that 1998 should be a short legislative session. High priority will be directed toward enacting employment law reform and reducing the frequency of frivolous lawsuits against government.