

Making (At Least Some) Sense
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Making (At Least Some) Sense of Personal Injury Law
As A Form of Social Insurance

by

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Though not often thought of this way, tort liability coverage for personal injury can be best seen as social insurance. Such a vantage invites the government to take a firm hand in shaping such coverage rather than leaving it to the market, as is largely done with other forms of private insurance whether life, health, disability or homeowners.¹ Social insurance can be defined as insurance coverage mandated by the government for losses – coverage that is so essential to well-being that society deems it impermissible for the populace to fail to be covered for such losses. Obvious examples are workers’ compensation, medicaid, medicare, along with old age benefits and total disability insurance under social security, etc. All these are mandated by state or federal legislation. Tort liability insurance is also mandated by law – in this case by common law rather than legislation, but law nonetheless. The common law in every state mandates that those liable for causing injury by their substandard conduct (or product) pay their victims’ losses. In the case of auto accidents, liability insurance for misconduct as defined by common law is indeed expressly mandated in one form or another for motorists by legislation in every state.² Furthermore, mandatory auto insurance

¹ Excerpted from JEFFREY O’CONNELL & CHRISTOPHER ROBINETTE, A RECIPE FOR BALANCED TORT REFORM (2008) [hereinafter Recipe].

² Jeffrey O’Connell et al., *The Comparative Costs of Allowing Consumer Choice for Auto Insurance in All Fifty States*,

statutes not only protect the assets of those who commit torts but impart rights to those they injure.³

Admittedly, tort liability insurance is not similarly legislatively mandated for, say, medical mistakes or malfunctioning products. But as a practical matter, any party – personal or corporate – potentially liable is compelled to purchase liability insurance based on the government’s common law dictate as to the legal consequences of such misconduct. Because tort liability is required by law, it follows that it should be viewed as a form of social insurance. Especially is this so since, on the other side of the coin, all who purchase goods or services are also, of course, required to pay for the tort liability coverage accompanying such purchases.

All this leads to the propriety, indeed necessity, for any government to structure this mandated insurance such that above all it seeks to protect those who suffer real need – namely those in almost any socioeconomic class seriously injured by tortious accidents whose losses outstrip all other applicable coverages.

It thus makes sense for tort liability coverage as social insurance to (1) limit transaction costs, (2) ensure that the populace need not buy coverage that pays for non-essential coverage, for

55 Md. L. Rev. 160, 214 (App. C), (1996).

³ E.g., Mass. Gen. Laws Ann., Ch. 175, § 113 ACS).

example, non-economic losses – especially when so much economic loss in our society from injury and illness is uncovered, and (3) eliminate the waste involved in double payment of any loss by both first-party and third-party insurers. With respect to that third item, it makes sense for tort liability coverage to eliminate the waste of insurance companies shifting money back and forth to prevent double payment by so-called ‘subrogation’ claims. The latter are brought against third-party liability insurers by first-party health or disability insurers to recoup amounts the latter have already paid for the victim’s medical expenses or lost wages.

In other words, these subrogation claims are brought against third-party liability insurers covering their insureds who allegedly (but only allegedly) have by their torts caused the need for earlier payment by first-party insurers to their insureds. They entail not only the waste of two insurers paying for the same lower loss but doing so at a time when more serious losses are often going unpaid from any source. Third-party liability insurance, along with first-party insurance, is very expensive and the more it is required to cover, the more expensive it is. Having liability insurers duplicate payment already made by other insurers obviously means less insurance available for those with unreimbursed losses from any source. Why? Because very little insurance (at least

in the U.S.) is sold without any limits. The more coverage that is included in third-party insurance the higher the cost, the lower the limits likely to be covered, and the lower the limits covered obviously the less insurance available to the most seriously injured. Under an early offers plan paying promptly for economic losses in excess of other coverages, one could expect less expensive higher limits of coverage, or at least better use of coverage even without higher limits.

It cannot be over emphasized that the United States is a tragically underinsured country for both illness and injury – and growing more so all the time. Those with no health insurance at all ever increase in number, close to 16% in 2005.⁴ (If it is true that the young (18-24) who are healthier and therefore need less health care are disproportionately among the uninsured (c. 40%), it is those very same youngsters who are disproportionately involved in accidents leading to tort suits.) Even those with health insurance are being required by their employers to bear more and more of their health care costs through any or all of the following: higher deductions from their pay, higher deductibles applied to any healthcare service rendered, or lower overall limits of coverage.

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U.S.Census Bureau, Health Insurance Coverage: 2005,

<http://www.census.gov/hhes/www/hlthins/hlthin05/hlth05asc.html>.

Health insurance for retirees is more and more disappearing. The cost of government supplied health insurance – primarily Medicare and Medicaid – already direly threatens state and federal budgets, threats that loom even much larger in the future, dwarfing even the huge potential costs of social security’s old age coverage. The percentage of Americans with disability insurance covering wage loss is indeed even far less than for health insurance.⁵ Pensions are disappearing for many or being severely lessened by the wholesale abandonment of defined benefit plans, replaced in turn by defined contribution plans with more and more of the burden of uncertainty falling on potential pensioners.

One has to admit that the dollars involved in tort liability coverage for personal injury, large as they are, can make only a small dent in sensibly supplementing economic losses payable by America’s notoriously inadequate health and disability coverage, whether public or private. For example, the United States now spends almost \$2 trillion annually on health care alone. But medical malpractice costs paid by doctors and hospitals, including self insurance, come to only about 2.5%

⁵ See U.S. DEPT. LABOR, BUREAU OF LABOR STATISTICS, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN PRIVATE INDUSTRY IN THE UNITED STATES, MARCH 2004.

of total health care expenditures. But still billions of dollars from liability insurance are available which if structured more sensibly could alleviate insurance shortages for many sorely in need while also substantially lessening the cost of liability insurance now misserving both an uninsured and underinsured public.

The resultant goal of an “Early Offers” statute would be to encourage prompt settlement of personal injury tort claims along first-party insurance lines, paying promptly for economic (but not for non-economic) damages to those whose losses outstrip all other applicable coverages. Payment for such losses will be made as they accrue. Its mechanics are simple: A defendant may at its option offer an injured claimant within the defined statutory period (*e.g.*, within 180 days of a personal injury claim) a settlement of periodic payments sufficient to cover a claimant's net wage loss and medical expenses, including rehabilitation, plus a claimant's reasonable attorney's fee, but without any allowance for pain and suffering. Other insurance (so-called collateral) sources paid or payable from the claimants' own or public coverages are deducted in computing the amount of the early offer (unless the legislature decides otherwise on this point). No defendant is forced to make an early offer, and, if no offer is made, normal common-law tort principles apply as to both liability and

damages. In making an early offer, however, the defendant triggers strong incentives for claimants: If the claimant accepts, that of course ends the matter. But a claimant who elects not to accept will face a higher burden of proof at trial, *i.e.*, beyond a reasonable doubt,⁶ with the defendant also judged by a higher standard of misconduct, *i.e.*, gross negligence.⁷

Consider a typical case to illustrate how the early offer law would work: A patient has been injured in the course of, say, medical treatment or the use of a manufactured product. If the claimant wins in court, she would be awarded \$1 million, but given the risks of litigation, she has only, say, a roughly 30 percent chance of winning. Thus roughly calculated, the patient has a claim worth about \$300,000 (a 30 percent chance at \$1 million). Assume the cost of setting aside a corpus of

⁶ Conceivably the legislation implementing an early offers plan could require proof by clear and convincing evidence.

⁷ A federal bill sponsored by Senator Mitch McConnell (R., Ky) authorized early offers for all personal injury cases except for auto accidents. S. 1861, 104th Cong. (1996). For a full discussion of the Early Offer reform and its effects on medical malpractice claims, see JONI HERSCH, JEFFREY O'CONNELL, & KIP VISCUSI, EVALUATION OF EARLY OFFER REFORM OF MEDICAL MALPRACTICE CLAIMS: FINAL REPORT (U.S. Dept. of Health and Human Services. Available at <http://aspe.hhs.gov/daltcp2006/medmalcl.pdf>. *Id.*, *An Empirical Assessment of Early Offer Reform for Medical Malpractice*, 32 J. Legal Stud. S231 (2006). For a similar study, see Jeffrey O'Connell & Patricia Born, *The Cost and Other Advantages of Early Offer Reform for General Liability Claims*, 2008 Col. Bus. L. Rev. 423.

money to pay the patient's net economic losses as they accrue is projected at about \$200,000, an often realistic assumption as data presented below will show. The insurer of the provider of pertinent goods or services would likely make the early offer, \$200,000 being clearly less than \$300,000. And a patient would likely accept, given that after an early offer, the claimant will have the normally insuperable burden of not only proving the relatively rare case of gross negligence but proving it beyond a reasonable doubt.

Now assume a change in the facts: same claimant, same provider, and same possible \$1 million verdict. But assume this claimant's chances of winning are only one in ten, with an expected value of \$100,000 (1/10 of \$1 million). Here the provider's insurer would not make an early offer – as it shouldn't, the case being very marginal with \$100,000 being clearly less than \$200,000. The fear of potentially higher costs to insurers under the early offer scheme is thus crucially avoided because, as emphasized, no defendants need make an offer if they would not do so without this statute. So defendants will make an offer only when it makes economic sense for them to do so, as shown in the above example.

It is vital to note that the early offer must in effect provide the claimant the equivalent of a

major medical/disability policy covering the claimant's net economic losses as long as they are reasonably accrued, similar to coverage under workers' compensation. In other words, a defendant cannot make a lesser or "low ball" offer and still gain the advantages of the early offer law. In this connection, once an early offer is tendered, that can be seen as imposing discipline on offerors by the transformation of the claim into a first-party one, thus subjecting the offeror to both more regulatory supervision by state insurance departments as well as claims based on bad faith for refusal to pay benefits, unlike the situation prevailing in adversarial third-party claims.⁸

It is also important to note, though, that an early offers plan does not threaten higher costs because defendants will not likely make early offers if they increase costs. This also serves as a safeguard against possibly expensive reactions to early offers reform by the plaintiffs' bar who cannot necessarily be expected to remain completely passive in the face of early offers reform.

⁸ The California Supreme Court in *Mordi-Shalal v. Fireman's Fund Insurance Co.*, 758 P.2d 58 (1988) abolished a third-party bad faith doctrine, overruling *Royal Globe Fire Insurance Co. V. Superior Court*, 592 P.2d 229 (1979). But as to dangers of increased claimant fraud from excessive demands on first-party insurers under auto no-fault claims *see* Robert E. Hoyt, David B. Mustard, & Lawrence B. Powell, *The Effectiveness of State Regulation in Mitigating Moral Hazard: Evidence From Automobile Insurance*, XLIX(2) J.L. & Econ. 427, 437 (Oct. 2006).

Note too that although injury victims tendered early offers would lose their recourse to full-scale tort litigation, they would correspondingly be paid without all those uncertainties, delays, and transaction costs they now face. Moreover, they would lose their recourse to full-scale tort litigation *only* when they are guaranteed prompt payment of their actual economic losses plus attorney's fees. These prompt and certain payments will, as emphasized, be especially advantageous to those severely injured patients whose losses have outstripped any other applicable coverage.

Rather than engage in often frustrating and futile litigation, with all its difficulties, delays, and costs, the injured and their alleged injurers would often do well to reach a quick settlement covering the victim's net out-of-pocket losses. But this rarely happens today. Just as claimants may sometimes feel they are "clearly" in the right, defendants understandably are opposed to paying for injuries which they dispute are the result of inadequate products or services. Some of these cases will, and perhaps should, be litigated. In the far more common debatable cases, however, where a prompt settlement may appear appropriate in light of the facts, or economically rational considering the expected transaction costs and delays of litigation, defendants and claimants are each reluctant

to offer an early settlement for only economic losses.⁹ This aversion is chiefly due to the war dance of distrust that likely pervades negotiations between deeply divided opponents (more on this shortly). In addition, the availability of damages for pain and suffering is based on the severity of injury, often measurable most easily by the amount of medical expenses and wage loss. This can induce claimants and their lawyers to inflate damage assessments and exaggerate actual injuries.¹⁰ But it is only fair here to focus also on similarly questionable defenses by defendants who take advantage of all the variables under tort liability by resisting even valid claims – especially if the claimant is in financial need. In other words, if, as defense interests argue, the tort system, with its opposing parties jousting over vague criteria, encourages exaggerated and frivolous claims, it also encourages exaggerated and frivolous defenses.¹¹

⁹ PATRICK S. ATIYAH, *THE DAMAGES LOTTERY* 142-43 (1997).

¹⁰See Jeffrey O’Connell & Ralph M. Muoio, *The Beam in Thine Eye: Judicial Attitudes Toward “Early Offer” Tort Reform*, 1997 U. Ill. L. Rev. 491, 495 (1997); see also H. LAURENCE ROSS, *SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENT* 151-63 (1970) (discussing claimants’ incentives to “build” their claims).

¹¹See Michael Horowitz, *Making Ethics Real, Making Ethics Work: A Proposal for Contingency Fee Reform*, 44 Emory L.J. 175, 184-86 (1995); see also JEFFREY O’CONNELL, *ENDING INSULT TO INJURY* 4-7, 16-18 (1975); JEFFREY O’CONNELL, *THE INJURY INDUSTRY* 64-65 (1971).

An early offers program creates a way to bypass these problems. In effect, in a kind of jujitsu maneuver an early offers program uses the overweight bulk of the tort system against itself. Thus, in return for promptly offering to pay claimant's net economic damages, a defendant protects itself from the vicissitudes of non-economic damages. But the message to claimants is clear: "If you want more than what insurance normally pays, namely your noneconomic damages, you had better be sure the defendant is not just arguably, but clearly very much, at fault."

And yet that does not mean that the early offer approach is overly favorable to those (allegedly) causing injury. First, only defendants willing to forgo obstructive defenses will be advantaged by the proposal. Second, defendants making early offers must still pay victims' net economic losses – which will usually be substantial – thereby significantly "internalizing" the cost of such accidents. The proposal could also include a minimum offer of, say, \$250,000 for serious injuries (realistically defined in the statute) when actual net economic losses suffered, say, by some youngsters, homemakers, or retirees, are relatively small. So early offerors are by no means getting a "free ride." Third, if no offer is made, or if the claimant, despite an offer, goes to trial and prevails, the claimant can recover pain and suffering or even punitive damages. This would mean reserving

awards of such non-economic damages to cases where liability for very wrongful conduct is quite clear or where a recalcitrant defendant unwisely declines to make an early offer.¹²

But won't insurance companies just "cherry pick" claims by making lower payments to clearly deserving claimants? No. Because of the uncertainty and cost of determining both liability and pain and suffering damages under present tort law, defendants in personal injury cases will likely make prompt early offers in many cases even when liability is unclear, a point also demonstrated by data presented below.

But why aren't early offers made now without a new law? Several factors make it unattractive for early offers to be made at present without an early offer statute. Defendants' insurers today are often confident of at least wearing down claimants, given the difficulties and

¹² Early offers reform has been criticized, for example, as overly favorable to defendants because it limits health care providers to making early offers only within 180 days of the *injury*, not the claim. But the latter would entail substantial risks of higher costs, precisely what early offers reform seeks to avoid. *Cf.*, David M. Studdert, et al., *Disclosures of Medical Injury to Patients: An Improbable Risk Management Strategy* 26 HEALTH AFF. 215, 225 (2007). It would also invidiously treat health care providers compared to other potential offerors since providers of goods could not realistically be subject to such a rule, in that typically they hear of an injury only by a claim.

delays in proving a tort claim. The long delay before trial, as seen, often enables defendants' insurers to bargain down even patients apparently clearly entitled to tort damages because of their need for immediate money for accrued and accruing medical bills and to make up for wage loss. Furthermore, insurers may fear that an early offer to settle for patients' net economic loss will be seen as simply encouraging claimants and their lawyers to seek an even larger settlement than originally sought. This mirrors the position of claimants and their lawyers, who similarly fear that an early offer to settle for only net economic loss would be deemed an admission of weakness on their side, resulting in either no payment or less than that claimed. So this vulnerability affects both sides.

There are also several reasons why damages for pain and suffering are not included in an early offer reform. In the first place, in reality, claimants relinquish only a portion of their pain and suffering damages under the early offers plan because they do not have to pay their lawyer a contingency fee of a third or more from the damages award – which now come out of pain and suffering damages.¹³ Furthermore, winning pain and suffering damages in the first place is subject

¹³ Clarence Morris, *Liability for Pain & Suffering*, 59 Colum. L. Rev. 476, 477 (1959); H. L. ROSS, SETTLED OUT OF

to all those contingencies of the current tort system. More importantly, the uncertainty of determining both liability and damages for non-economic damages is the key to understanding the inefficiencies of tort law and to framing a balanced solution that attempts to be fair to both injured parties and providers of goods and services. Pain and suffering damages are indeterminate and highly volatile. But under an early offer system, the prospect of paying pain and suffering damages still serves as a means to deter health care providers' medical mishaps. In effect, the threat of paying damages for noneconomic damages, rather than actual payments, better serves injured persons, as well as the public interest, by providing leverage for prompt payment of economic losses.

Pain and suffering damages also differ from economic damages from the standpoint of insurance generally. Consumers as a practical matter do not purchase pain and suffering insurance as part, say, of their first-party health or disability insurance.¹⁴ Indeed, no such voluntary insurance market for payment of non-economic losses from personal injury exists. In contrast, of course, consumers routinely buy insurance coverage for their economic losses, which, of course, is the focal

COURT, 108 (1970).

¹⁴ See W. Kip Viscusi, *Pain and Suffering: Damages in Search of a Sounder Rationale*, 1 Mich. L. & Pol'y Rev. 141 (1996).

point of the early offer proposal.

And here we reach a crucial point: *Because personal injury claims alone among all other damage claims routinely entail damages for both economic and non-economic losses, defendants are uniquely positioned not only to make but to enforce by early offers socially attractive settlements for only economic loss. In non-personal injury claims (such as for breach of contract or even tortious property damage), where only economic damages are at stake, no comparably fair means are available to sanction a claimant who refuses to accept an offer of only a portion of the total losses claimed.*

The most common criticism of any no-fault model is that, while the reduction of full-scale tort litigation may provide for improvements in aggregate efficiency and compensation, these are supposedly outweighed by the dangers of insufficient deterrence and resultant threats to safety.

But lawyer-economist Jason Johnston has described tort law's deterrence failings as arising out of the difficulty in determining *a priori* the optimal standard of care for providing particular goods or services, combined with the difficulty for those deciding the case to determine whether

those standards have been met in any given case.¹⁵ Johnston argues, though, that significant improvement can be achieved by manipulating both the requisite standard of care and the burden of proof in tort suits.¹⁶ According to Johnston, juries and even judges often can't separate careful from negligent conduct nor negligent from grossly negligent conduct. That doesn't mean, however, that they can't separate careful from grossly negligent conduct, especially if liability after an early offer is predicated on proof beyond a doubt of defendant's gross negligence. Under such criteria, when a defendant in fact takes reasonable steps, as a practical matter there will surely be no evidence beyond a reasonable doubt of his or her gross negligence.¹⁷

To illustrate Professor Johnston's point, as the following table shows on a scale of one to ten it is often difficult for a judge or jury to tell the difference between, say, 4 and 5 or between 8 and 9. But not so the difference between 4 and 9.

Due Care	Negligence	Wanton Conduct
1-4	5-8	9-10

A provider of goods and services behaving within the range of 1-4, before the early offers law might

¹⁵Jason S. Johnston, *Punitive Liability: A New Paradigm of Efficiency in Tort Law*, 87 Colum. L. Rev. 1385, 1399 (1987).

¹⁶*Id.* at 1411-12.

¹⁷ *Id.* at 1411-12 (citing *Burk Royalty Co. v. Walls*, 616 SW2d 911, 918-19 (Tex. 1981).)

well have feared being liable for conduct within, say, the 5-6 range. But after a statutory early offer of claimant's net economic loss, a provider need not fear very clear proof of conduct in the 9-10 range. Deterrence of provider's unsafe conduct is additionally served by forcing any party straying into the range of 5 or more to stand ready to pay any victim's net economic loss. And the more one drifts into the range of 5-8, the more one faces the threat of full-scale tort – and even punitive – damages.

The ability to thus discriminate between extremes will make the imposition of full-scale liability for providers of goods and services much less erratic and random, greatly lessening the often counterproductive (even pernicious) effects of unpredictable litigation that looms over providers of goods and services. Even if determinations of gross misconduct and noneconomic damages would still on occasion have to be assessed, the need to so assess would be greatly reduced since, as seen, relatively few defendants can be expected to breach the higher standard of misconduct under the early offers regime, and the efficacy of this higher standard of misconduct (e.g., gross or even intentional misconduct) is also reinforced by the need to prove it by a higher burden of proof. These 'twin peaks' of (1) gross misconduct (2) beyond a reasonable doubt, it will be noted, mirror

criminal standards. Under these quasi-criminal law standards for both misconduct and proof thereof, unjust cases of false positives whereby innocent defendants are held liable would mostly disappear, and the economically detrimental effects of overdeterrence greatly assuaged. Nevertheless, false negatives whereby guilty defendants are held not liable are also avoided by requiring defendants to pay economic losses in order to avoid full scale liability. Indeed, early offers, by making tort law much more swift and certain, if less severe, may well enhance its deterrent effect. Deterrence is also addressed by maintenance of unrestricted liability, in the form of pain and suffering and punitive damages, for gross negligence – levels of misconduct that would expose one to such full-scale damages.

The early offer configuration is in fact a two-tiered model of tort liability that retains non-economic damages at the rarer upper, or punitive, level of personal injury law, while most often eliminating them at the much more commonplace lower, or compensatory, level. Accordingly, it is therefore a hybrid system that seeks, as stated above, to compensate in a manner consistent with first-party no-fault coverage, but nevertheless maintains the third-party fault-based system in modified, but much more effective, form. First and third party insurance will thus be effectively coordinated far better than for current tort claims: There will be neither wasteful double payment

to claimants nor wasteful claims by first-party insurers seeking to recoup their payments to their own insureds via tort claims against the third-party insurers of those who injured the first-party insureds.

By retaining a crucial quantum of tort's most potent weapon of non-economic damages, the early offers system also generates an enormous torque capable of promoting deterrence. Although overall uncertainty is greatly reduced, the threat of an uncertain measure of damages for gross misconduct continues to serve as a coiled threat which encourages safe, cost-effective behavior. In addition, providers of goods and services who avoid the threat of tort law's most extreme penalties by early offers must internalize their adverse results by those very early offers. Meanwhile, patients and consumers, protected with full tort rights in the event of clearly egregious conduct, will be much more likely to receive prompt and suitable compensation through early offers in the much more common cases of injury caused by ordinary mishap.

What will be the cost of an early offer program?

An analysis of studies of actual court settlements and verdicts in medical malpractice cases in Texas and Florida¹⁸ and product liability cases in Texas¹⁹ indicates the comparative performance

¹⁸ JONI HERSCH, JEFFREY O'CONNELL & KIP VISCUSI, *supra* note 7. Jeffrey O'Connell, *The Large Cost Savings and*

of the early offers program vis a vis the present tort system.

A. Medical Malpractice Cases (using \$ 2002)

Looking at Table I below, with the insurers' decision on whether to make an early offer based on whether the price they are tentatively willing to pay – their reserve – is less than the claimants' net economic losses, of the 1,938 claimants in the study suffering severe nonfatal injuries paid under tort law, 1,186 (or 60 percent) would be tendered early offers (Ia3).²⁰ Severe nonfatal injuries are defined as brain damage or spinal cord injuries with complications. The cost savings from paying such claimants by early offers would average \$584,000 per claim (Ia3). Payment would be made on average 2.4 years faster from the time of the claim than under tort law (Ia2). (Actually, because the 180 day period for a defendant to make an early offer runs from the time of claim, claims subject to early offers will in all likelihood be made much sooner than present tort claims. Thus the 2.4 years figure is very conservative.²¹) Total litigation costs on both sides would be

Other Advantages of an Early Offers "Crimtorts" Approach to of Medical Malpractice Claims, 17 Widener L.J. (2008).

¹⁹ Jeffrey O'Connell & Patricia Born, *supra* note 7.

²⁰ Hersch, *et al. supra* note 17.

²¹ On the conservative estimate of the time saved, *see* RECIPE, *supra* note 1, at 148, note 4.

reduced by an average of \$225,200 per claim (Ia4).

Table I

Medical Malpractice: Severe Nonfatal Injuries (1938 of Whom Paid Under Tort)

	1	2	3	4	5
	Percent of Claimants to Whom an Early Offer is Made	Time Saved Under Early Offer per Claim	Average Total Cost Savings per Claim [N]*	Litigation Cost Savings per Claim [N]	Reduction in Average Payment per Claim [N]
a Based on Initial Reserve	60%	2.4 years	\$584,000 [1,186]*	\$225,500 [1,055]	\$321,500 [1,055]
b Based on Final Reserve	96%	2.4 years	\$1,470,000 [1,915]	\$334,500 [1,893]	\$357,500 [1,893]
c Based on Actual Payout	100%	2.4 years	\$1,177,000 [1,938]	\$560,500 [1,932]	\$357,500 [1,932]

* Number of tort payees to be paid by early offers

An important element of the cost study of early offers is that insurers' initial (or early) dollar reserve allocated to pay a typical tort claim often turns out to underestimate a claim's ultimate value. In Table I, as opposed to average savings per case of \$584,000 using initial reserves as the base for calculating savings (Ia3), they would equal \$1,470,000 per case using final reserves (just before a case is resolved) (Ib3) and \$1,177,000 using actual ultimate payout as the base (Ic3).²² Similarly, average litigation costs drop by

²² Why are the initial reserves so much lower than the final reserves or actual payouts? There are several possible explanations. The fact that initial reserves are well below the others does not *necessarily* imply that insurers are under-reserving on average with their initial reserve amounts. The cases observed in the data set are the successful claims that led to insurer payouts. If, for example, the insurer reserves the same amount for claims of a particular type with this

\$225,500 per case based on initial reserves (Ia4) versus by \$334,500 and \$560,500 under final reserves and payouts respectively (Ibc4). Also out of possible 1,938 cases, the number of injured patients receiving early offers grows from 1,186, based on initial reserve (Ia3) to 1,915 and to all 1,938 under final reserves and payouts respectively (I bc4). So the larger the anticipated final reserve or actual payout compared to the initial reserve, the greater the incentive for insurers to set a more realistic and therefore higher initial reserve, leading in turn to more and higher early offers plus lower litigation costs. Admittedly, insurers

amount corresponding to the average claim costs, then the claims that are ultimately successful will be under-reserved initially, while unsuccessful claims will exhibit over-reserving. Thus, the selection of claims for inclusion in the data set could alone account for the observed pattern without any bias in the reserving practices. Moreover, as the claim matures, the insurer will learn more about the claim, distinguishing which claims in this overall claims category are those with the highest expected losses. But that there may be systematic errors in loss reserving is well documented. Weak insurers have a tendency to under-reserve to make their financial soundness appear brighter. See Kathy Ruby Petroni, *Optimistic Reporting in the Property-Casualty Insurance Industry*, 15 J. of Accounting and Economics 485 (1992). In addition, the amount of reported reserves may be affected by income smoothing objectives and tax concerns. See Jennifer J. Ganer and Jeffrey Paterson, *Managing Insurance Company Financial Statements to Meet Regulatory and Tax Reporting Goals*, 16 Contemporary Accounting Research 207 (1999), and Elizabeth V. Grace, *Property-Casualty Insurer Reserve Errors: A Theoretical and Empirical Analysis*, 57 J. of Risk and Insurance 28 (1990).

cannot know the amount of the later reserve or final payout at the time they are estimating the initial reserve.

But with an early offer program in effect, insurers would have an incentive to analyze claims more carefully at an earlier stage. Even without adjusting upwards the initial reserve values to reflect the likely greater research that will occur in setting reserves under an early offer regime, the data indicates widespread opportunities for successful early offers in cases of severe injury.

The same pattern holds true for fatalities and for all cases, including less severe injuries.

For example, for the 4,609 death cases the average savings per case would be \$377,500 based on the early reserve and \$675,500 based on the final reserve, with average litigation costs per case reduced respectively by \$107,000 and \$147,000.

For all 15,916 cases together, i.e., larger, smaller and of medium size, the average savings per case would be \$241,500 based on the early reserve and \$556,500 based on the final reserve (IVab3), with average litigation costs per case reduced respectively by \$82,500 and \$130,500. The same faster timing of payment holds true in all categories of cases.

On the debit side of all this, as Table 1 also shows, based, for example, on the initial reserve, the average early offer reduces payment to such claimants by \$321,500 per claim. In addition, as will be shown

below, very few claimants (3%) would receive more under an early offer than they would have under a tort claim.

These latter figures raise a legitimate question: Even with early offers promptly covering essential losses with far lower costs, are those advantages under early offers justified? Some will clearly differ on this. But it would seem that tort law's uncertainties, with concomitant delays and high transaction costs, do indeed make the trade worth it, especially for severely injured patients, about whom after all any insurance scheme should be primarily concerned.

But, as seen above, one could lessen discrepant payments under early offers compared to payments under present law for, say, those suffering little economic loss after severe nonfatal injuries (or death). Thus as also seen above, a provision could be added to the statute requiring that an early offer entail, at the option of the payee in such a case, payment of either net economic loss or a minimum of, say, \$250,000. This floor of \$250,000 would reduce the number of claimants whose compensation is lower under the early offer system, from 1,055 to 498, with the percentage of claimants gaining in compensation rising from that low of 3 percent mentioned above to 29 percent. On the other hand, the higher minimum offer means that the number of severe nonfatal injury cases receiving early offers would be reduced from 1,190 to 540, with the

remaining claimants consigned to the harrowing vicissitudes of the current tort system.

B. General Liability Claims (using \$2007)

The pattern for all general liability claims, including those for product liability, paid under tort attracting early offers follows very closely that for medical malpractice cases. The general liability study separated claims in which workers' compensation were also paid and not thus paid. The workplace cases were fewer but larger in losses, savings and deductions from collateral sources.²³

Some typical figures from the general liability data are set forth in Table I below for severely injured claimants not covered by workers' compensation. The average savings per case based on the final reserve were \$1,055,500 (Iib3)²⁴; the time saved was the same 2.4 years as for medical malpractice claims (Iib2);

²³ As to the latter, we conservatively estimated that such deductions for workers' compensation would be more than twice as large (60% versus 25%) due to the comparatively generous workers' compensation benefits for medical expenses and wage loss. Twenty percent of all general liability claimants paid under tort law in the Texas sample were also paid by workers' compensation (a higher percentage than the somewhat dated figure of 10% mentioned in RECIPE, *supra* note 1, at 152.

²⁴ Versus \$1,207,000 for workplace cases. See RECIPE, *supra* note at 168, Table VI b 3 [VIb3] along with *id.* Tables

and litigation savings based on the initial reserve were \$197,000 (IIa4).²⁵

Table II

Product Liability – Not Covered by Workers’ Compensation: Severe Nonfatal Injuries (822 of Whom Paid Under Tort).

	1	2	3	4	5
	Percent of Claimants to Whom an Early Offer is Made	Time Saved Under Early Offer per Claim	Average Total Cost Savings per Claim [N]	Litigation Cost Savings per Claim [N]	Reduction in Average Payment per Claim [N]
a Based on Initial Reserve	56%	2.4 years	\$636,000 [457]	\$197,000 [457]	\$266,500 [398]
b Based on Final Reserve	96%	2.4 years	\$1,055,500 [789]	\$246,000 [789]	\$285,000 [777]
c Based on Actual Payout	100%	2.4 years	\$894,000 [822]	\$418,000 [822]	\$284,500 [819]

Indeed across the board not only for severe injuries but for death and all cases combined including less severe injuries, general liability claims (both with and without workers’ compensation also being paid) like medical malpractice cases provide widespread opportunities for making early offers. Thus, there are: (1) very large savings per case resulting from early offers; (2) more payees and much higher savings if the comparison is based on the final reserve or actual payout; (3) the same faster payment; (4) much lower transaction costs; and finally; (5) the high percentage of severely injured offerees (or their survivors) losing money from an early offer being greatly

VII through XI, at 168-70.

²⁵ Versus \$227,000 for workplace cases. *Id.* at Via4, at 168.

diminished by a minimum alternate payment of \$250,000. But here too this is achieved at the price of more claimants forced to face dysfunctional tort law.

Having been exposed to the remarkable results projected for an early offer system, one is in a position to recognize the extent to which, from the rigorous perspective of economics, the early offers plan dramatically shrinks the grounds of dispute between claimants and defendants in personal injury litigation. That difference between the parties is characterized by economists as a “wedge.” Reducing that wedge between the parties is the essence of the early offers device. Because few rational claimants will go to trial once an early offer is made, with the probability of a claimant prevailing so low and a socially adequate and binding offer open, many more cases will be settled quickly and less expensively. After all, the outcome of a post-early offer is clear to both parties.²⁶

Absent a rare defendant’s quasi-criminal misconduct, the claimant who litigates further will almost certainly lose. Nor can the early offer itself be subject to all that much controversy; its value is largely preset by statute. The inverse of Judge Richard Posner’s economic insight comes into play, namely that the more the parties are apart by a wide range of possible bargaining outcomes, the more

²⁶ See generally George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. Legal Stud. 1 (1984).

the likelihood of prolonged litigation.²⁷ Early offers, by leaving relatively few if any realistic issues to bargain over, enormously reduces the likelihood of disputation.

This is in contrast to the present situation when the wedge leads to what economists in another term call a ‘deadweight loss.’ An analogy may help: Economists see taxation as a deadweight loss for consumers and producers in that it represents a net transfer from them to the taxing authority (plus to accountants and lawyers). Similarly the wedge created by tort law creates an even greater deadweight loss (without the benefits from taxation, dubious as the latter may seem to some) in that it results in a net transfer, not in this case from consumers and producers but, from claimants and defendants to attorneys and others (insurance companies, expert witnesses, etc.) involved in litigation. This deadweight loss is a net loss to society in that it can be seen as representing defendants who would have been willing to offer a prompt and reasonable settlement of the workers’ compensation type to claimants willing to accept it. Both are prevented from doing so because, as seen, the wedge drives them apart.

The wedge, in turn, is caused in significant part by what the economists characterize as

²⁷ RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 21.5, at 253 (3d ed. 1986).

“asymmetric information,” which in this instance describes things this way: In personal injury cases today the defendant is normally the party with better information regarding its true liability to the claimant, and tries to signal no or low liability to the claimant through a low or even no settlement offer. But a claimant is normally the party with better information regarding, say, her conduct and the extent of her harm, and will attempt to signal, for example, a higher level of harm with higher demands or a higher counter-offer.²⁸ These signals, by transmitting information, may conceivably increase settlements by diminishing the disparity of expectations – *if* believed. Normally however, the opposing parties are inclined to discount the other’s signals as “cheap talk,” or exaggerated versions of true valuations. And so expectations may well diverge further.

The economist sees this asymmetry of information as a major stumbling block in litigation. Keep in mind that the adversarial nature of a lawsuit, with its almost inevitable disagreement between the claimant and the defendant about a trial’s likely result, is exacerbated by dispute between them over any vagueness of the legal standard in dispute. The vaguer the standard, the

²⁸ Andrew F. Daughety & Jennifer Reinganum, *Asymmetric Information Acquisition and Behavior in Role Choice Models: An Endogenously Generated Signaling Game*, 35 Int’l Econ. Rev. 795, 795-97 (1994).

greater the uncertainty as to any given case's outcome, and the greater the probability of extended litigation. And personal injury claims present their own special causes of disagreements because, as repeatedly seen, of the vague legal standards over who or what was at fault and the economic value of non-economic losses.

There are thus inexorable obstacles to claimants and defendants finding what each needs in the way of evidence. So asymmetries persist. The search for a solution becomes a choice between attempting: (a) to improve the signals given by each party, or (b) to find a way to bypass the signaling process. In trying (a), to improve signaling, the law through many decades of frustration in the twentieth century formulated so-called "discovery" proceedings whereby under judicial supervision each party is entitled to extract information about the other's case. But as just a further indication of the law's failures, the discovery process has simply added its own huge inadequacies to personal injury litigation, leading to "fishing expeditions" being met by tactics of "hide and seek."

In 1938, the Federal Rules of Civil Procedure (often followed by states as well), formulated discovery rules which, as Professor Richard Epstein of the University of Chicago Law School points out, "were drafted under the influence of . . . world views which saw litigation as a collaborative

search for truth instead of a regulated form of combat. Yet no matter how we sugarcoat it, all litigation constitutes a form of aggression which both sides seek to explore by devising ways [in the discovery process] to inflict heavy compliance costs on their rivals at little cost to themselves.”²⁹

And all the while an overworked and harried trial judge (often without much success) tries to keep the peace in an adult version of schoolyard fist-a-cuffs.

But even if the discovery process could somehow work, the problem in personal injury litigation turns out *not* to be so much asymmetric information but largely *unknowable* information. This in turn stems from the uniquely unmanageable variables in such litigation (unwelcome as all this may be to economists, enamored as they are with the concept of perfect information). According to a lawyer and a physician who together exhaustively examined medical malpractice litigation in New York, Colorado, and Utah, “the legal system is even more prone to error than the medical system it attempts to judge.”³⁰

²⁹ Richard A. Epstein, *Legal Sanity ‘Discovered’*, Wall St. J., May 24, 2007, at A17.

³⁰ Jeffrey O’Connell & Andrew S. Boutros, *Treating Medical Malpractice Claims Under a Variant of the Business Judgment Rule*, 77 Notre Dame L. Rev. 373, 375 (2002) (citing Howard Hiatt & Paul Weiler, *No-Fault Medical Coverage Would Cure Many Ills*, Boston Globe, Nov. 5, 1999, at A27).

As a result, in rejecting (a), trying to improve signaling, we turn to (b), finding a way to bypass it. This is indeed accomplished by creating such strong incentives for each party to settle via an early offer, that the parties' expectations are brought together. We are thus able to avoid the economist's asymmetric information problem with its concomitant wedge and deadweight loss without having to solve the insoluble asymmetry itself, thereby averting the largely futile task of trying to create better signaling by the opposing parties.³¹

New York Times business writer Joe Nocera has titled one of his columns *Forget Fair; It's Litigation As Usual*. It concerns the many product liability claims arising from Merck's pain medicine Vioxx, with its alleged increased risks of heart attack or stroke. But Nocera's words are applicable to other areas of personal injury claims as well. According to Nocera:

There are many problems with viewing . . . lawsuits as a means to right wrongs, which is how we see them in this country. They often make lawyers rich while the people who say they were hurt wind up with very little. . . . [Tort suits] have become

³¹ For an economic model of how early offers can shrink the wedge and reduce deadweight losses, see RECIPE, *supra* note 1, at 187-97.

a rogue form of regulation, and not necessarily in the public interest. And finally, when you get right down to it, litigation is a crapshoot, and can be cruelly unfair. . . .

As a result, a handful of lucky people who may have been the victims of their own bad habits – and not of Vioxx – won large sums of money (although they haven't seen a penny yet: every case the plaintiffs won is on appeal). And some people who may well have suffered because of Vioxx lost their cases and didn't get a penny. How can such a system even approximate justice . . . ?

There has to be a better way, doesn't there?³²

How about Early Offers?

³² Joe Nocera, *Forget Fair; It's Litigation As Usual*, N.Y. Times, Nov. 17, 2007, at B1, B8.