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Tort reform and the theory of coordinating tort and insurance

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ABSTRACT

An important ingredient of tort reform is the substitution of the traditional – in Common Law – Collateral Source Rule for a system of deducting insurance payments from the tort award. In the paper we offer a comprehensive analysis of the effects of the mechanisms to coordinate tort and insurance payments on the three essential decisions involved, namely precaution, risk coverage and litigation. We undertake the analysis for the *Collateral Source Rule* (cumulation), benefits offset (deduction), and subrogation of insurer. In the presence of a liability system, the problem of coordination makes sense only in a world in which liability rules do not operate perfectly. Under an imperfect strict liability regime, we show that solely subrogation can induce optimal incentives for risk coverage. In addition, collateral offset dilutes injurer's incentives to take care as compared to the other two regimes. Under an imperfect negligence regime, incentives to buy coverage under the collateral source rule are lower. Under collateral benefits offset, the victim may prefer to ignore tort payments entirely, buying full insurance and leaving the injurer with no incentives for precaution. The paper also discusses the litigation decision and the apparently strong advantage in terms of administrative costs of the collateral offset rule over subrogation, and points out several factors that might undermine this presumed advantage.

1. Introduction

We aim to illuminate the theoretical underpinnings of different coordination schemes involving Tort and insurance payments. Our specific purpose is to explore the variations in the determination of Tort damages and their interaction with the insurance coverage decisions of the injured party. We present a general theoretical model of the effects of the main rules to coordinate Tort awards, and insurance and similar benefits, on three dimensions that we think are essential in understanding the problem: risk coverage, incentives for accident prevention, and litigation and related administrative costs.

To coordinate insurance and Tort, three rules have been adopted by different legal systems in various fields and to various degrees. We will consider all three: The first, rule A, is the traditional "Collateral Source Rule" which has been the target of Tort reform efforts. This rule allows the victim of an accident who has received insurance or similar benefits to collect full damages from a liable injurer, disregarding what was received from private, social insurance or other sources (hence the name).

The second legal solution, rule B, is the opposite of the Collateral Source Rule, and has been implemented in many places, including many US States following Tort reform: the amount of the insurance benefits received by the victim is deducted from the damage payment the injurer is liable for. We call this option "benefits offset", or "deduction", given its effect upon the Tort award.

In the tort reform process more than half of the US states[1] have either abolished or modified, totally or partially, the pre-existing Collateral Source Rule, allowing evidence of the payments of insurance or similar benefits in favor of the victim, or directly mandating the offset of the collateral benefits against the tort award that will be payable by the injurer. And the US is not alone in this, since other countries have also taken steps along similar paths.[2]

The third option, rule C, is to allow the insurer to seek reimbursement from the liable injurer of the benefits paid to the insured.[3]

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[1] See, Avraham (2006) for the collection of State tort reform Laws that affect, *inter alia*, the Collateral Source Rule.
[2] For the UK, see Law Commission, Consultation Paper No 147, Collateral Benefits (1997), and (Lewis, 1999, pp. 43–46).
[3] We do not explicitly consider in the paper the Unlimited Insurance Subrogation (UIS), advocated by Reinker and Rosenberg (2007) for medical malpractice. UIS would comprise in the subrogation rights of the insurance company not just the benefits paid by the insurer to the victim, but the entire tort claims of the victim against the liable injurer. We are not aware that this proposal has taken up with any actual legal system.

This can be implemented technically in a variety of ways: allowing a direct cause of action of the private or social insurer against the injurer; subrogating the insurer in the Tort claim of the victim; compelling the insured to transfer her Tort claim to the insurer, or, in some cases, assuming that that has been the case; imposing a lien in favor of the insurer on the victim's Tort award, or allowing his participation, side by side with the victim, in the civil liability claim. Throughout the paper we will refer to this option as "subrogation", but our results would apply as well to the other schemes just mentioned.[4]

It might be observed that the last rule and the other two are not mutually exclusive in strictly logical terms. We could imagine the insurer being reimbursed for its payments and, at the same time, the victim being entitled to the full damage award payment. Or the insurer subrogated in the Tort claim to the amount of the benefits paid, while the victim will retain her own claim but will face the offset. As for the first situation, even if theoretically possible, it is inconceivable if one wants to avoid liability in excess of harm. The second one is very much real: The question is that, in order to prevent double liability of the injurer, insurance subrogation must necessarily entail either (i) a bar of any Tort claim by the victim herself if insurance coverage was full, and thus, she was made whole or; (ii) a reduction of the award if coverage was only partial. And this implies that the benefits offset is, as such, an essential part of the insurance subrogation scheme, and that the former only acquires existence and distinctiveness as an independent rule precisely when it contradicts the latter, that is, when the benefits are deducted from the damage award and subrogation is at the same time excluded.

The three alternatives just described are the main ones used by legal systems to organize the co-existence of Tort damages and insurance benefits, private and public. Subrogation may be, to a certain extent, the result of a contract provision agreed between the parties to the insurance contract, although this is only possible if the background rule imposed by the Law on the Tort case does not exclude subrogation, as happens when the rule is to offset benefits. It must be borne in mind, thus, that we are dealing with systems imposed by the Law – although subrogation could simply be a default rule for the insurance contract that the parties are allowed to alter if they so choose.

Moreover, coordinating Tort and insurance requires a setting of an imperfectly operating Tort system. The problem of coordinating disappears entirely in an ideal world in which liability rules operate perfectly. The point is easily shown: take as given a certain type of harmful event. Assume that strict liability is the rule in force, and that it operates perfectly. Then, in this ideal world, the strict liability rule provides victims with payments that are equivalent[5] to those from an insurance company. The presence of perfect strict liability destroys the possibility of an insurance market for those risks, as potential victims will not pay the price of insurance in the market when they can enjoy the same coverage for free through the legal system. However, in cases governed by the negligence rule, there is plenty of room for the purchase of accident insurance by potential victims. But when this rule operates perfectly, in equilibrium injurers always take optimal care and, consequently, are never held liable. Therefore, a victim or her insurer cannot expect to recover anything from a liable injurer, and the coordination of payments never becomes an issue.

The adequate framework in which to analyze the problem of connecting liability awards and insurance benefits is one of imperfect liability rules. The paper presents what we believe to be the first general formal economic analysis of the three coordination schemes of Tort and insurance, and their effects on the main incentives involved, namely: risk coverage, precaution, and litigation. In prior literature, Levmore (1982) informally considers similar issues. Danzon (1984) points out that it is in the best interest of potential victims to subscribe insurance policies containing subrogation provisions for their insurers. Shavell (1987) demonstrates Danzon's intuition, and shows that subrogation also leads to the social welfare maximizing contract between insurer and insured, in the presence of liability. Shavell, however, does not examine the three alternatives, does not consider different liability regimes, does not allow for imperfect liability rules, and does not address the litigation dimension. Sykes (2001), independently from us, presented a related model intended to illuminate the issue of injurer's insolvency and how the optimal insurance contract containing subrogation provisions would allocate the reimbursement of insured and victim against a limitedly solvent injurer. Sykes' paper concentrates on optimal insurance subrogation clauses, allowing for non-pecuniary losses, unfair premiums, and moral hazard of the insured, complications not considered in our model. His paper does not consider, however, the various liability rules that may be in place, the incentives for the injurer to take care, nor litigation. Very recently, some proposals in the field of malpractice liability advocate the revitalization and even the expansion of subrogation as the preferred policy alternative both in terms of deterrence and of avoidance of frivolous Tort litigation: Reinker and Rosenberg (2007). In fact, our formal results in this paper tend to provide some theoretical support to their broad positive attitude towards subrogation.

The paper will be organized as follows: Section 2 presents the basic model and a reminder of the social welfare maximization conditions. Section 3 considers the three alternative legal regimes with a risk-neutral injurer facing imperfect strict liability. Section 4 examines a negligence rule with uncertainty in this same setting, and Section 5 addresses the issue of litigation and administrative costs in the light of the results in the previous sections. Section 6 reviews the empirical literature on the issue so as to place our contribution in the context of actual policies of coordination of insurance and Tort.

2. The model

The basic (standard) assumptions of the model are outlined first. Further assumptions will be made in later sections, but the following basic ones will hold throughout the paper.

(1) A risk averse potential victim and a potential injurer face a positive ($0 < p_x < 1$) probability of accident.
(2) Both the victim and the potential injurer are taken as representative of a large population of victims and potential injurers where each individual is small (atomic) so there is no pairwise strategic interaction in their decision-making.
(3) The accident will determine a fixed loss $L > 0$ to the victim. The loss is assumed to be monetary.
(4) The accident is unilateral, and p_x is decreasing and strictly convex in x, the amount of care taken by the potential injurer.
(5) The victim has a *Von Neumann-Morgenstern* utility function of wealth, v, which is increasing and strictly concave. The injurer has also a *VN-M* utility function of wealth, ϕ, and is risk-neutral. Initial wealth for both agents is normalized to zero.

[4] Even with respect to strict subrogation, there are certain complexities that will be ignored in our analysis, such as the sharing rules among insured and insurer in their actions against the liable party. These rules are relevant when the liable injurer has limited assets, a problem that will not be expressly addressed here. On this, see Sykes (2001).

[5] Eventually, with the help of the award of pre-judgement-interest and attorney's fees.