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Who Pays in the End for Injury Compensation - Reflections on Wealth Transfers from the Innocent

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Who Pays in the End for Injury Compensation? Reflections on Wealth Transfers from the Innocent

ALFRED F. CONARD*

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The *ALI Study*, like most juristic discussions of injury compensation, gives generous attention to the desserts of injury victims and to deterrent effects of liability on the persons who are held liable. These analyses say little about the innocent human beings from whom wealth is transferred through the tortuous paths of liability and insurance. The individuals from whom wealth is transferred might be dubbed “victims” of the compensation system, but I will call them by the more neutral term of “contributors,” and examine the merits of exacting their contributions.

Very few of the actual contributors are the ones whom the law holds liable. The law assesses liability against individuals whose clumsy, careless, or reckless movements or unwise decisions precipitate injury (the “malefactors”) and against the enterprises that employ the malefactors or purvey defective products. Since individual malefactors are generally insured or judgment-proof, they seldom pay. Most payments are made by enterprises that have employed or insured the malefactors, or purveyed the faulty products.

Although enterprises pay large sums each year for injury compensation, their wealth rarely shrinks in consequence. Most of them recover their expenditures by charging higher prices to their consumers, or by reducing the benefits that they confer on investors, workers, and the general public. The consumers, the workers, the public, and the investors (or the investors’ constituents) are the innocent human beings who contribute.

The identity of the real contributors is masked in judicial procedure and in legal and economic theory by a charade that treats compensation as a transfer from a faulty individual or enterprise that “caused” the injury. The charade is enshrined in rules that forbid counsel from talking about the insurance system through which wealth is transferred from a wide population of investors, workers, consumers, and taxpayers and transferred to an army of lawyers.

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3. This simplistic conception was captured in Robert D. Cooter’s statement that “[i]njury law can price an externality by making the *injurer* strictly liable for any damage caused, thus creating incentives for efficient behavior. When “strict” liability applies, the *injurer* who caused the harm must compensate the victim, even if the *injurer* was not at fault.” Cooter illustrated the principle by the liability of a manufacturer for consumer injuries. Robert D. Cooter, Economic Theories of Legal Liability, 5 J. Econ. Perspectives 11, 12 (Summer 1991)(emphasis added).
insurers, and court personnel, along with injury victims.\(^4\)

Jurors and judges are not wholly unaware of the charade. They know that individual malefactors seldom pay, and that most of the money comes from the treasuries of insurance companies and business enterprises, but they seldom ask who replenishes the treasuries. With the real contributors out of sight, jurors and judges can view with serenity the duplication of payments and the diversion of half the transferred wealth to lawyers and insurers, while they imagine that their damage awards are scaring malefactors and products purveyors out of their injurious ways. If, on the other hand, the transfers were perceived as subtractions from the food, clothing, and shelter of human beings who have played no part in the injuries that are compensated, decisionmakers might take a more critical view of how much is taken from the contributors, and to whom it goes.\(^5\)

The fact that tort compensation is ultimately supplied at the expense of innocent humans should not prejudice us against it. Many social benefits, like free schools, prisons, and Medicaid, are supported by taxpayers who had nothing to do with creating the need for them. The fact should, however, lead us to observe carefully which of the benefits conferred by tort law are worth the costs that they impose on contributors.

I propose here to disregard the charade and to inquire who are the men, women, and children who contribute the wealth that is transferred by systems of injury compensation and what are the merits of making them contribute. The question that I address is what kinds of losses justify forcing the innocent to contribute, either by reason of their addition to welfare, or because of their incentive to reduce injuries. From this perspective, I will examine the various objectives of compensation, such as buying health care, replacing wage loss, offsetting pain, and promoting safety, and speculate on the extent to which these transfers accomplish accepted societal objectives. Along


According to WRIGHT & GRAHAM, supra at 437, the rule has attracted the "collective scorn of writers." But the rule was defended by Calman, supra.

\(^5\) See JEFFREY O'CONNELL, THE LAWSUIT LOTTERY 87-88 (1979) on possible advantage to defendants of jurors' awareness of the effect of awards on insurance premiums.
the way, I will suggest reforms that seem to balance more benefici-
cially the welfare of actual and potential injury victims and the wel-
fare of contributors.

I. CONTRIBUTORS

"Injury compensation" suggests to most readers—at least, most juristic readers—compensation that is compelled by tort law. The transfers impelled by this system are the primary subjects of this symposium, although they are a minor fraction of all the wealth transfers made for the benefit of injury victims. A RAND study estimated the tort fraction of total injury compensation at about 7 percent. For the sake of perspective, I will mention briefly non-tort systems by which wealth is transferred to the victims of injury.

A. Contributors Through the Tort System

For a preliminary view, I will mention a few of the most obvious classes of contributors to injury compensation, some of whom contribute chiefly in theory, and others in reality.

1. Malefactors

In some small fraction of cases, the individual perpetrators of wrongful harms are the ultimate contributors of compensation. This can happen when a malefactor is unconnected with any employment, the malefactor is not covered by liability insurance, and the malefactor has enough nonexempt assets to be worth suing. Such cases are rare, since owners of significant assets generally insure themselves against liability, and owners who lack significant assets are generally immune to enforcement of money judgments.

Although the amounts contributed by malefactors are economi-
cally insignificant, the fantasy that they contribute plays a major role in framing perceptions of compensation systems. This fantasy enables jurors and jurists to applaud awards for pain, for loss of en-
joyment, and for the punishment of gross misconduct which appear less admirable when the real contributors are discerned.

2. Other Purchasers of Liability Insurance

Most of the payments that are made to discharge the liability of individual malefactors are not made by the malefactors, but by their insurers. A familiar example occurs when a private motorist negligently injures a victim, and the motorist's liability is discharged by

6. DEBORAH R. HENSLER ET AL., RAND INSTITUTE FOR CIVIL JUSTICE, COMPEN-
sATION FOR ACCIDENTAL INJURIES IN THE UNITED STATES 175 (1991).
his or her liability insurer. The insurer is a conduit for premiums paid by thousands of motorists. The principal actual contributors are other individuals who have bought liability insurance from the company that insured the malefactor. The malefactor's share of the premiums, even if the malefactor's own premium is increased after the accident, is usually a tiny fraction of the amount paid by the insurer to settle the claim.

Even when a negligent motorist has neglected to buy insurance, innocent insurance purchasers are likely to contribute to compensation, because they are "required or semi-required" to buy coverage for uninsured motorists, as well as for themselves.7

3. Constituents of Malefactors' Employers

When an injury is caused in the course of a business enterprise, compensation is generally paid initially by the enterprise or its insurer. Since enterprise premium rates are usually adjusted to reflect loss experience, the enterprise may be regarded for present purposes as the payer, whether or not it is insured.

Since most enterprises continue to thrive in the face of mounting liabilities for personal injury, they must obtain from someone else the means to discharge their liabilities. Enterprises are conduits for the transmission of resources to injury victims from investors, consumers, workers, and other constituents.8 When enterprises pay, these constituents are the humans whose wealth is diminished.

Which of the major constituencies—consumers, investors, or employees—bear in the final analysis the costs of injury compensation

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8. Peter Huber treated the costs of accident liability as a tax on consumers, without mentioning investors or workers. He considered it also as an additional tax on taxpayers, but only by reason of the liability of municipalities and other tax-supported institutions. PETER HUBER, LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES 3-5 (1988). Guido Calabresi, however, recognized that under conditions of severe unemployment or monopoly, the costs might be borne by the unemployed or by investors. GUIDO CALABRESI, THE COSTS OF ACCIDENTS 80-85 (1970).

depends on many circumstances. When an enterprise incurs liabilities that are much greater than those of its competitors, it presumably reduces its returns to investors, who become contributors to injury compensation. But when the enterprise is bankrupted, workers and communities are likely to suffer even more severely than investors. If, however, most of the competitors of an enterprise incur similar liabilities, they all raise their prices or reduce the quality of their products, so that the ultimate contributors are consumers.

If consumers resist higher prices, workers may suffer from layoffs and wage freezes, so that they become contributors. More remotely, enterprises may reduce donations to charities, or reduce emission controls, so that the residents of ambient communities join the contributors of injury compensation.

The largest of the investors are also conduits. Over half the shares of U.S. companies are held by institutions, comprising pension funds, bank trusts, mutual funds, insurance companies, and charitable endowments. In 1990, pension funds held more than a quarter of all shares, while bank trusts, mutual funds, insurance companies, foundations, and endowments divided another quarter. When the returns of investors are diminished, the beneficiaries of all these institutions, of whom the largest sector are pensioners, become contributors. For simplicity, I will use the term “investors” to include the individuals who are the beneficiaries of pension funds, trusts, insurance, foundations, and other institutions that hold the securities of enterprises.

If the product market is elastic while capital and labor markets are inelastic, consumers are likely to become the principal contributors. If product and labor markets are inelastic, investors probably become the main contributors, and so on. Since all the markets that exist outside academic classrooms have some degree of elasticity, all the individuals affected by enterprises, including even the residents of ambient communities, are likely to make some contribution to the compensation of injuries.

10. Id. This source estimated the percentage holdings of the various types of institutions in 1990 as follows:

<table>
<thead>
<tr>
<th>Type of institution</th>
<th>Percent of equity held</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private pension funds</td>
<td>19.9</td>
</tr>
<tr>
<td>Bank trusts</td>
<td>9.2</td>
</tr>
<tr>
<td>Public pension funds</td>
<td>8.3</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>7.2</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>6.9</td>
</tr>
<tr>
<td>Foundations/endowments</td>
<td>1.8</td>
</tr>
<tr>
<td>Total</td>
<td>53.3</td>
</tr>
</tbody>
</table>

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4. The Public

A little noticed effect of injury compensation through the tort system is its impact on taxes. \(^\text{11}\) Payments made to discharge liability or to buy liability insurance are deductible from taxable income, reducing the taxes paid by enterprises. \(^\text{12}\) When enterprises pay less taxes, other citizens have to pay more, or suffer a diminution of government services. Besides, taxpayers contribute to support the courts that administer the tort system. The innumerable men, women, and children who contribute in these ways to injury compensation I call the "public."

B. Contributors by Contract

Besides the individuals from whom contributions are exacted through the operations of tort law, there are others who contribute through the medium of insurance contracts that are bought for the direct benefit of injury victims, without regard to tort law.

1. Other Purchasers of Individual Loss Insurance

Many injury victims carry various kinds of health insurance that pays their hospital and doctor bills, and life insurance that pays on their deaths. A few carry disability insurance, too. When the underwriters of these kinds of insurance pay for injuries, the contributors are other buyers of loss insurance, rather than of liability insurance.

2. Constituents of Victims' Employers

Employers probably pay directly or indirectly more compensation for personal injuries suffered by their employees than for personal injuries caused by their employees. They buy health insurance that covers their employees and often members of employees' families for injuries that are unrelated to employment. They replace some lost wages with sick leave. They buy workers' compensation insurance.

\(^\text{11}\) HUBER, supra note 8, at 3-5, characterized tort liability as a "tax" because its costs are passed on by enterprises to consumers. My point here is that some of the costs escape consumers and other enterprise constituents because they are passed to the U. S. Treasury by deducting liability payments and liability insurance premiums from taxable income.

\(^\text{12}\) Joseph M. Dodge recognized the blunting of deterrence by the deductibility of liability payments in the course of discussing the differences in the deterrent effects of different levels of liability. He did not question the principle of deductibility. Joseph M. Dodge, Taxes and Torts, 77 CORNELL L. REV. 143, 173-78 (1992).
that pays for medical expenses and lost wages of employees injured at work.

These payments for employees' losses, like those for employees' liabilities, must be made up from increased income or decreased costs. They too fall, in the end, on investors (including pensioners), workers, consumers, and the public.

C. Contributors Through Public Benefit Programs

The needs of injury victims are also filled in part by government programs such as disability benefits under Social Security, Medicaid, and Aid to Families with Dependent Children, and by public hospitals to the extent that they are unable to collect payment for their services. The ultimate contributors to these programs are taxpayers.

II. OBJECTIVES OF COMPENSATION

A. Welfare Objectives

1. Relieving Distress

The most basic objective of injury compensation is to relieve distress, chiefly by paying for medical treatment and by replacing earnings. These objectives are worth achieving at the expense of any of the possible contributors, including the general public, if there are no more appropriate donors. The main question in regard to wealth transfers for these purposes is which of the possible contributors are the most appropriate, considering procedural expense, incentives to reduce injuries, and resource allocation.

There are other subjects of compensation that serve social objectives only when imposed in such a way that they deter injurious conduct. A cardinal example is payment for retribution and punishment, or "punitive damages." To assess these in a way that allows them to be passed on to the general public, residents of ambient communities, consumers, workers, and investors is punishing the innocent to deter the guilty.

Another subject of compensation that calls for critical re-examination is pain. Debates on pay for pain generally focus on whether it is an appropriate subject for compensation by anyone, considering the difficulty of evaluating it, and the doubt that payments assuage

pain more than the contemplation of payments aggravates it.\textsuperscript{14} Although the answers are inconclusive, most legislators who have addressed the question have refrained from outlawing damages for pain, even while limiting their amount.\textsuperscript{15}

When we turn from who should be compensated for pain to ask who should contribute to pay for pain, the only obvious candidate is a malefactor who caused it. This liability is intuitively appealing because of its presumed deterrent value, and probably also for the retributive satisfaction that it may give to the sufferer.

When we turn from malefactors to innocent consumers, investors, and workers, we are at a loss for considerations that support making them contribute to compensate the pain of others.\textsuperscript{16} Some of them may be appropriately required to pay for medical care that will alleviate pain; the cost of medical care may fairly be viewed as a part of the cost of a harmful product, which should be borne by all the product’s consumers. Moreover, popular responses to news reports of tragic injuries indicate that contributions to medical care as well as to food, clothing, and shelter are stimulated by contemplating the pain of an injury victim. But not even the most generous humanitarians have been heard to advocate handing money to sufferers of pain beyond supplying their material needs.\textsuperscript{17}

There is even less support in politics or ethics for making the general public pay for pain, as it does when damages for pain are passed to the U.S. Treasury through tax deductions. While twentieth century legislators have expanded explosively the variety and volume of

\begin{itemize}
\item \textsuperscript{14} A recent exposition of medical, psychological, and philosophical treatments of pain did not even mention payment of money. \textsc{David B. Miller, The Culture of Pain} 174-87 (1991). A survey of the physiology of sensation noted that pain is stimulated or intensified by contemplating it. \textsc{Diane Ackerman, A Natural History of the Senses} 101-04 (1990).
\item \textsuperscript{16} Schwartz, \textit{supra} note 7, at 426-27. Schwartz pointed to the ultimate absurdity of requiring automobile owners to insure against their own pain by way of compulsory uninsured motorist insurance, which gives the owners a right to sue for the pain that they suffer from the negligence of an uninsured motorist.
\item \textsuperscript{17} Shelly Kagan characterized as the position of a moral “extremist” the view that one should give one’s money to the hungry and one’s time to the lonely to the extent of one’s resources, but did not suggest that giving money to those suffering pain would appeal even to an extremist. \textsc{Shelly Kagan, The Limits of Morality} 1-2 (1989).
\end{itemize}
wealth transfers for welfare, they have yet to authorize payments for pain. To make taxpayers pay for pain through the deductibility of damage payments is incompatible with any known public policy.

We are left without any welfare gain in forcing anyone to compensate pain. Whether there are incentive gains will be considered later.

2. Minimizing Contributions

Since contributors are just as human as injury victims, compensation systems enhance aggregate welfare only when they confer benefits that are more important than the detriments imposed on contributors.

The balance of benefits and detriments is complicated by the fact that under the tort system, about two dollars must be abstracted from contributors in order to confer one dollar of benefits on injury victims. The aggregate of present monetary wealth of innocent victims and innocent contributors is inevitably diminished in favor of lawyers, insurers, and court personnel.

These transfers are nevertheless worth making if they rescue injury victims from a destitution that is more tragic that the modest deprivations imposed on contributors. They are even more beneficial if they facilitate restoration of injury victims to productive lives.

If, on the other hand, the benefits conferred on victims provide only minor ameliorations of a living standard that is about the same as that of most contributors, the transfer of wealth at a ratio of two detriments to one benefit reduces, rather than enhances, aggregate

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18. Joseph W. Little opposed elimination of compensation for pain on the grounds that it would cause "great expense to the poorer strata of the population," and would allow malefactors to escape personal responsibility for wrongful acts. Joseph W. Little, Reducing Noneconomic Damages by Trick, 26 San Diego L. Rev. 1017, 1024 (1989). He did not explain how the poorer strata would incur any more expense than any other strata; one might suspect, intuitively, that the poor would lose less because of inferior access to attorneys. 2 ALI Study, supra note 1, at 208, recognized that the case for damages for pain and suffering was "uneasy," but proposed retaining them, apparently on the ground that they are a commitment of the existing law of torts, and should not be retrenched without an accompanying provision for awarding attorneys' fees.

welfare. The adverse ratio of monetary benefits to monetary detriments accentuates the importance of making no transfers beyond those of which the benefits per dollar are twice as important as the detriments.

One obvious way of avoiding unproductive transfers is to avoid collecting twice for the same cause. When wages that have been recovered through sick leave and medical expenses that have been discharged by health insurance are recovered again as tort damages, aggregate welfare is inevitably diminished.

An easy cure for double recovery is to repeal the “collateral benefit rule,” which allows recovery for all the harm done by an injury without regard to whether it has been or will be paid for from a collateral source. But repeal is sometimes opposed on the ground that tort damages should include the losses compensated by collateral benefits in order to produce an appropriate level of deterrence and resource allocation.

If channeling all losses through the tort system is a valid objective, it could be served by means that are more efficient than duplicating collateral benefits. Tort law could allow claims for losses that are collateralistically compensated only when the collateral compensators are joined as co-plaintiffs with injury victims. For example, an injury claim might be filed jointly on behalf of the victim, the victim's employer (who has paid sick leave), the victim's health insurer (who has paid medical expenses and expects to pay more), and the victim's employer's workers' compensation insurer (who has paid or will pay for wage loss beyond sick leave). I will call this proposal a “joint recovery system.”

The joint recovery system would be quite different from that of existing law, which reimburses collateral benefactors only when they initiate suits for subrogation. The right of subrogation, which achieves perfect justice in the rarefied atmosphere of economic analysis, is generally neglected in practice because the expense of investigating and suing exceeds expected benefits. Under the joint recovery system, attorneys for an injury victim would have to discover the collateral benefactors and join them as claimants, or else deduct their benefits from the damages claimed on behalf of the

20. This is the recommendation of the ALI Study. 2 ALI STUDY, supra note 1, at 176-77.
However, the expenses of channeling recoveries through the tort system are much greater than handling them through other devices. The tort route has been shown to consume about half of its costs in administration, whereas private loss insurance consumes only about twenty percent of its costs in administration, and social insurance even less. The administrative costs of awarding sick leave have not been measured, but seem likely to be very low. The saving of expense that is achieved by compensating through non-tort paths may benefit victims in some cases and contributors in others, but seems worth pursuing for either purpose.

The welfare objectives of injury compensation would be better served by making the necessary wealth transfers through nonfault systems, as proposed by Stephen Sugarman. The only reasons for retaining the tort system seem to be its propensities to inspire safety practices and to allocate resources from more dangerous to less dangerous activities. These propensities will be examined in the following pages.

B. Incentives to Reduce Injuries

Contemporary tort theorists tend to focus less on the welfare objectives of injury compensation systems than on incentives for reducing injuries, commonly described as “deterrents.”

While tort liabilities certainly provide some incentives to avoid injurious conduct, they do so clumsily. Neither juries nor judges are provided with principles with which to determine how much liability

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22. This proposal differs from the alternative described and rejected by 2 ALI Study, supra note 1, at 177-78, in that claimants would not be required to notify collateral source beneficiaries if they found it burdensome; they could simply omit the duplicated benefits from their claims.

23. CONARD ET AL., supra note 19, at 59, estimated private loss insurance administrative costs at about 20 percent and social insurance costs at about 2 percent. Danzon, supra note 19, cited a 20 percent overhead expense rate for large group private health and disability insurance programs. 1 ALI Study, supra note 1, at 440, reports an estimate of administrative expenses in workers’ compensation at 15 to 20 percent, but does not compare administrative expenses of private loss insurance or social insurance. The ALI Study avoids comparison of administrative expenses of these systems of compensation, although it reviews at 129-80 the magnitude and coverage of their benefits.


25. A torts-teaching colleague has suggested that the tort system may “promote emotional or psychic well-being” by its affirmance of the rightness of a plaintiff and the wrongness of a defendant. Similarly, I have heard lawyers asserting that the tort system vindicates a public “sense of justice.” I have not seen any reports of interviews indicating whose sense of justice is vindicated. My own ears report more nonlawyer perceptions of the tort system as a travesty of justice than as a paradigm.

is enough but not excessive, nor how it should be assessed in order to fall on individuals who have some capacity to reduce injuries. Lacking guidance, courts impose liabilities in ways that allow them to be shifted to a wide population of investors, consumers, workers, and the public who have no way of affecting safety practices.

In order to use injury compensation as a tool for reducing injuries, damages must be assessed with a view to maximizing their impact on the individuals who can reduce the incidence of injuries. "Punitive" or "exemplary" damages need to be radically redesigned to motivate conduct efficiently. If revised for this objective, they might be renamed "incentive damages." I will outline some of the features that would remold punitive or exemplary damages to maximize incentives to reduce injuries, while minimizing contributions that do not serve this purpose.

1. Incentives of Individual Actors

Although individual malefactors seldom pay damages, tort law provides them with two kinds of incentives to avoid inflicting injury. I will speak first of the incentive to avoid causing injuries in the course of activities that are unconnected with their employment. In these activities, a low degree of incentive flows from their individual liability.

For some potential malefactors, the incentive force of liability is close to zero because they do not have enough assets to be worth suing.27

For most of the potential malefactors who possess significant assets, the threat of liability is diluted by liability insurance.28 When

27. Under earlier "financial responsibility laws," liability provided some incentives because drivers who lacked assets or insurance might lose their licenses for failure to pay judgments. See Robert E. Keeton & Jeffrey O'Connell, Basic Protection for the Accident Victim 103-05 (1965). The incentive was weak because victims had little incentive to seek judgments against uninsured assetless drivers. These laws were generally superseded by "financial responsibility laws," which threatened drivers with loss of their licenses if they could not prove either ownership of assets or coverage by liability insurance. Id. at 105-09.


In softening the deterrence of liability, insurance does not completely eliminate it. See Schwartz, supra note 26. Cooter, supra note 3, at 26-27, also recognized the mollifying effect of insurance; his discussion was directed principally to the liability of enterprises for harmful products. With these types of defendants in mind, Cooter noted the possibility that the deterrent-muffling effect of liability insurance might be offset by its tendency to reduce injuries because insurers monitor the activities of insureds.
malefactors' liabilities are discharged by their insurers, the malefactors may find their insurance premiums increased, so that they have some incentive to avoid causing injuries, but it is usually a tiny fraction of their liability.\textsuperscript{29}

The incentive of higher insurance premiums could be enhanced with a reduced impact on other insurance purchasers if insurers were free to raise premiums as much as they deem advantageous by reason of a purchaser's loss experience.\textsuperscript{30} Unfortunately, insurance regulators commonly restrict the extent to which insurers can raise individual rates. The liability system would exert greater safety incentives with lower costs to innocent individuals if insurers were freed from regulatory restrictions on experience-based rates.

The incentive force of liability could also be increased by forbidding insurers to discharge malefactors' liabilities, or subjecting coverage to a deductible threshold. But this would reduce the chances that injury victims would receive full compensation. Consequently, insurance should continue to be allowed for compensatory damages. But it should be forbidden for incentive damages, the principal purpose of which is to motivate potential malefactors rather than to relieve distress.

Excluding insurance would enhance the impact of liability on malefactors, and prevent their passing on the costs of injuries to other insurance buyers. In order to facilitate the exclusion of insurance of incentive damages, juries and judges should be required to separate their awards for monetary losses from their awards for incentives.

But the incentive force of individual liability is dubious at best.\textsuperscript{31} In this context, tort theorists generally speak of "deterrence," a word that embodies the concept of molding human conduct by terror. Like deterrence of murder by capital punishment and deterrence of drug-dealing by long sentences, deterrence of injurious conduct by tort liability assumes a degree of rationality and calculation that is more frequently observed in academic seminars than on the streets.

For individual actors who cause injuries in the course of their employment, the main incentive is probably the fear of being demoted or fired for causing an injury that brings liability on the employer.

\textsuperscript{29} SHAVELL, \textit{supra} note 21, at 241, conceded that actors' safety incentives are reduced by insurance, but argued that insurance which covers the full expected liability has the countervailing advantage of reducing the level of the activity from which injuries are likely to arise.

\textsuperscript{30} Id.

\textsuperscript{31} FRIEDLAND \textit{et al.}, \textit{supra} note 28, at 65-75. A recent nonlegal treatise on factors that affect driver involvement in automobile accidents examined the role of age, sex, education, alcohol, occupant protection devices, and TV driving scenes, but made no mention of the threat of liability. \textit{Leonard Evans, Traffic Safety and the Driver} (1991).
This fear is moderated by employers' uncertainty about whether one offending employee is more dangerous than a replacement is likely to be, and even more by the difficulty of proving that the offender is more dangerous, when the employer is charged with unreasonable termination of a dangerous employee. But it retains some force. The incentives that flow from employers' power over employees depend on the liability of the enterprises that employ the actors, which is the next subject for examination.

2. Incentives of Enterprises

The most important incentive effect of enterprise liability is the impulse that it gives employers to introduce systems that inhibit unsafe conduct. Truck owners may equip their trucks with speed recording devices, or post 800 numbers on their trucks, inviting motorists to complain of dangerous driving. Automobile manufacturers may create a corps of safety engineers who participate in product design. These kinds of accident prevention have expanded in recent decades in response to liability threats. In addition, liability motivates enterprises to select their employees with a view to accident reduction and to discipline or discharge employees that prove to be more than normally faulty.

These considerations lead to a number of observations on useful magnitudes and impacts of liability.

a. The Magnitude of Assessments

In determining the magnitude of incentive assessments, courts need a set of criteria that are quite different from those that have been established for punitive damages. The "wealth" of the corporation has nothing to do with the amount of liability that will motivate safety practices. Although the ALI Study supports this observation, the alternatives offered by the Study do not seem significantly more functional.

The amount of liability that is most likely to motivate enterprise managers to reduce accidents is an amount that equals or exceeds

32. The argument for this obvious observation is articulated in 2 ALI STUDY, supra note 1, at 253.

33. See 2 ALI STUDY, supra note 1, at 256-59, discussing limits based on multiples of compensatory awards. The amount that is appropriate for the compensation of loss seems as irrelevant as wealth to the amount that would motivate safety practices. If compensatory awards were reduced by deducting collateral benefits and awards for pain, as I suggest, compensatory awards might be too small to be worth suing for.
the costs of an accident reduction program. Experts have tested safety programs in various industries, and could testify to the probable costs of attaining specified reductions. If a defendant has already been assessed damages for the same dereliction, additional assessments should be limited to the amounts required to supplement prior assessments that were inadequate.

Although compensation for pain is an inappropriate basis for awards against enterprises, pain would be appropriately considered by jurors and judges in deciding how strong an incentive to create for injury reduction.

In deciding how powerful the incentives should be, judges and jurors need to remember that most of the liabilities imposed will be passed on to enterprise constituents and the public. It is no wonder that jurors assess astronomic damages for pain and punishment when they are allowed to imagine that judgments are satisfied from some bottomless pitcher called “insurance,” and forbidden to consider where the money comes from. Rather than setting arbitrary ratios of incentive to compensatory damages, we should at least try providing jurors and judges with information about whose pocket will be picked.

In view of the heavy demands of time and money that would be required by a scientific determination of incentive damages, there is some danger that defendants would be coerced into paying thousands of dollars simply to avoid the expense of trial, and that bold claimants could win big settlements merely by threatening to demand incentive damages. But similar dangers exist under present law. Under more relevant criteria, settlements seem likely to come closer to efficient levels.

b. Maximizing Behavioral Impacts

Although all enterprise liability creates some incentive to reduce injuries, its motive force can be greatly enhanced, while reducing its

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35. See Paul M. Carren & Richard B. Pazornik, Demonstrating Ethical Responsibility: Inventing a Self-Governance Program, in Corporate Lawbreaking and Interactive Compliance: Resolving the Regulation-Deregulation Dichotomy 71 (Jay A. Sigler & Joseph E. Murphy, eds., 1991) [hereinafter Sigler]; Joseph E. Murphy, Corporate Counsel’s Role in Interactive Compliance, in Sigler, supra, at 91.

CED, supra note 8, at 82, presents some estimates of the costs of various safety programs in relation to lives saved.

36. The cumulation of incentive damages should be controlled by various devices such as those discussed in 2 ALI Study, supra note 1, at 260-62.

37. See O’Connell, supra note 5, at 87-88 on the possible advantages of jurors’ awareness of the impact of liability on premiums.

Cf. Calman, supra note 4, at 1228-44, who rejected various proposed solutions to the problem of insurance awareness, but did not discuss the possibility of revealing who are the ultimate contributors of payments made by insurers.
burden on innocent bystanders, by fixing the incidence where it will have the greatest effect on behavior.

An ingenious suggestion for placing liability on corporations where it will have the greatest incentive effect was made by John Coffee in relation to fines for corporate crimes. He proposed that instead of imposing heavy cash fines, which may bankrupt companies and punish creditors, employees, and suppliers, courts should impose fines in shares. In order to avoid dilution of their share values, shareholders, whom Coffee characterized as “the constituency most able to change corporate behavior,” would demand that corporations comply with the law.

The ability of shareholders to affect corporate behavior is often substantial in closely held companies, but very slight in those that are publicly held. In publicly held corporations, the persons to be motivated are the managers, who are the real decisionmakers in most large corporations. They, too, may be motivated by dilution of share values, since their compensation is often related to the market price of shares. Since share-fines would not impair cash flow, they would not diminish the ability of the enterprise to invest in safety programs, which may require heavy expenditures on labor and equipment.

Similarly, damage awards in shares could be imposed for personal injuries in class actions, where the awards would be large enough to bear the costs of registering the awarded shares in order to sell them on public markets. But share-damages are not adaptable to most injury liabilities, where the awards are less than a million dollars.

A more practical way of enhancing the impact of tort liabilities would be to deny the deductibility of tort damages from taxable income, just as the law now denies the deductibility of criminal fines. When liability payments are deducted from taxable income, as the tax law now permits, the net cost to a profitable corporation is only 66 percent of the payout. The other 34 percent is offset by a tax saving, through deducting the liability payment from corporate income. In effect, only two-thirds of the liability is discharged at the expense of the enterprise and its constituents. The other third is discharged at the expense of the U.S. Treasury, and eventually at the expense of other taxpayers. If damages were made nondeductible,
the financial incentive to reduce injuries would be enhanced by almost half. The denial of deductibility would not save consumers, workers, and other enterprise constituents from eventually bearing some part of the costs of liability. Since the denial would reduce returns to investors, enterprises might have to recover the loss by raising prices or reducing employee benefits. But the shift of costs to the U.S. Treasury, and thereby to other taxpayers, would be attenuated, while the safety incentives of managers would be intensified.

c. Occasions for Assessment

In order to avoid imposing incentive damages when they serve no useful purpose, they should be assessed only against enterprises which have demonstrably failed to make reasonable efforts to reduce the dangers of injury. An interesting model for this kind of liability in a very different context can be found in the Insider Trading and Securities Fraud Enforcement Act of 1988, which makes employers liable to treble-damage penalties when they knowingly or recklessly disregard dangers of violations of securities laws.

40. This argument was advanced with regard to punitive damages in Note, Should Punitive Damages be Nondeductible? The Expansion of the Public Policy Doctrine, 68 Tex. L. Rev. 819 (1990); Comment, The Deductibility of Punitive Damages as a Ordinary and Necessary Business Expense, 26 San Diego L. Rev. 357 (1989). It was briefly mentioned in Note, An Economic Analysis of the Plaintiff's Windfall from Punitive Damages Litigation, 105 Harv. L. Rev. 1900, 1918 (1992).

An argument favoring the deductibility even of fines, which are currently nondeductible, was expounded by I.P.L. Png and Eric M. Zelt. I.P.L. Png & Eric M. Zett, Efficient Deterrence and the Tax Treatment of Monetary Sanctions, 9 Int. Rev. L. & Econ. 209 (1989). This argument, if accepted, would apply even more forcefully to the deductibility of punitive and other damages in civil actions.


41. The ALI Study is emphatic on this point. 2 ALI Study, supra note 1, 243-48. Cf. President's Council of Competitiveness, Agenda for Justice Reform in America 22 (1991); CED, supra note 8, at 103-05.


Harvey Pitt and Karl Groskaufmanis have proposed that enterprises should not be liable for any damages when they have conformed with codes of conduct adopted by the enterprises themselves. See Harvey Pitt & Karl Groskaufmanis, Corporate Codes of Conduct and Corporate Self-Regulation, in Sigler, supra note 35, at 27 (1991); Harvey Pitt & Karl Groskaufmanis, Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct, 78 Geo. L.J. 1559 (1990). This proposal differs radically from mine in that it would excuse enterprises from compensatory damages, rather than from incentive damages, when codes have been complied with. Moreover, it proposes to base liability on codes framed by the enterprises themselves; this seems like appointing the fox to watch the henhouse.
Since private litigants would have difficulty proving that enterprises have recklessly disregarded dangers, injury victims who have proved the negligence of an employee or the defect of a product should be given the benefit of a presumption that the employer negligently disregarded dangers. Enterprises would bear the burden of rebutting the presumption by proving that they have made reasonable efforts to reduce injuries. Examples of presumptive liability are supplied by the federal Securities Act of 1933 and Securities Exchange Act of 1934, both of which make “controlling persons” liable for securities offenses by controlled persons, subject to rebuttal by proof of the controllers’ innocence.\(^4\)

Other examples of presumptive enterprise liability are found in many countries, of which the most neatly formulated may be the German Civil Code, which imposes a prima facie liability on employers, but excuses those who observe the care in directing employees and in providing utensils that are required in the trade.\(^4\)

This solution contrasts sharply with the recommendation of the \textit{ALI Study}, which not only assumes that a plaintiff should bear the burden of proof of the required degree of fault, but proposes to require the rigorous standard of “clear and convincing evidence” instead of a mere “preponderance.”\(^4\) This requirement sounds reasonable when one visualizes a suit against an individual malefactor, but presents a formidable obstacle to a suit against a large corporate organization, whose safety programs are invisible to an outsider. Even if a complaining victim might procure evidence through discovery procedures, the facts could be brought to light more expeditiously by requiring the enterprise to produce them to prove its exercise of due care.

d. Incentives for Claimants and Attorneys

Liability provides safety incentives only when someone enforces it. If tort law were completely excluded from injury compensation, as Sugarman proposed,\(^4\) private individuals would have no incentives


\(^4\) BGB § 831(1) (1896); for an English translation, see \textit{German Civil Code} § 831, para. 1 (Loewy trans. 1909). For comment, see 2 \textit{Konrad Zweigert & Hein Kötz, Introduction to Comparative Law} 337-39 (2d rev. ed. 1987).

\(^4\) 2 \textit{ALI Study, supra} note 1, at 248-49.

\(^4\) \textit{Sugarman, supra} note 24, at 127-52.
to identify the malefactors responsible for their injuries, and to overcome the denials of malefactors and their employers.

Sugarman believed that governmental agencies could gather data on the causes of accidents, and assess appropriate liabilities. But government agencies would have a hard time discovering injuries and their causes if victims had no incentive to accuse malefactors. Government agencies are also vulnerable to capture by enterprises through contributions to political candidates.

Incentive damages would not only provide incentives for actors to avoid causing injuries, but also incentives for victims to sue. Since they would be awarded in addition to compensatory damages and collateral benefits, attorneys' fees could be awarded from incentive damages without impairing compensation for victims' economic losses. If incentive damages provide an insufficient base for attorneys' fees, courts could award additional amounts.

The ALI Study, in rejecting the suggestion that assessments for pain should take the form of fines payable to the state, suggests that awards to injury victims on account of pain serve the useful purpose of generating funds to pay attorneys' fees. Although the Study recommends that attorneys' fees be made the subject of specific awards, it implies that pay for pain should be tolerated until a better method of paying lawyers' fees is established.

Covering attorneys' fees is a poor reason for preserving awards for pain. So long as attorneys' fees can be masked as awards for pain, lawyers will have no reason to devise more rational methods of rewarding their services.

e. Retribution and Punishment

When damages have been assessed to relieve distress and to motivate injury avoidance, additional awards to satisfy injury victims' outrage (retribution) or to intensify malefactors' remorse (punishment) serve no purpose that would justify the exaction of contributions from an innocent public, or the exertion of judicial authority. Awards of this kind are more likely to encourage injury victims to nourish their anger than they are to assuage it.

47. Id. at 153-65.
49. This possibility is fully explored in 2 ALI Study, supra note 1, at 267-318.
50. 2 ALI Study, supra note 1, at 215.
51. 2 ALI Study, supra note 1, at 315-16.
C. Resource Allocation

Besides relieving distress and deterring injury, the tort system is sometimes credited with allocating resources away from zones of activity that are more injurious to other zones that are less so. Since liability and insurance against liability make dangerous activities expensive, people look for other activities that are less expensive because they are less injurious. In the words of Carl Shapiro, “[E]conomists have ceaselessly pointed out that when one party is made liable for an injury caused to another, an externality has been internalized.”

A neat illustration of the concept is supplied by Guido Calabresi’s hypothesis about the liability of automobile owners. As the costs of automobile insurance are increased by liability for injuries, consumers are supposed to spend less on automobiles and more on safer modes of transportation, like busses and railroad trains. If we suppose that all motorists create the same danger of injuries, we can imagine that the costs of liability will induce citizens to reduce their driving until the costs of alternatives modes of transportation exceed the costs of liability and insurance against liability.

If we accepted the notion that burdening activities with their accident costs allocates resources efficiently, we would favor channeling all injury compensation through the tort system, so that the activities that generate injuries would be appropriately reduced. We would also want to make sure that all the injuries that now escape the tort system because they are too small or because proof is too difficult should be brought into litigation by appropriate incentives for attorneys.

In practice, some of the resource allocations produced by tort liability seem to be the opposite of what anyone would approve. The malpractice liability of physicians has made health care more expensive, not only by increasing the amounts that physicians must be paid in order to cover their insurance premiums, but also by inducing them to undertake excessive testing in order to ward off liability. By making health care more expensive, liability has


53. Calabresi, supra note 8, at 70-72.

contributed to a reduction in the number of persons covered by health insurance because former buyers can no longer afford the premiums.

But higher health care prices have not induced people to suffer less accidents or diseases, as allocation theory would require. By making health care less available, liability has aggravated rather than alleviated problems of sickness and injury.

One reason why medical practice liability leads to misallocation may be that jurors blame doctors for misfortunes that are not the doctors' fault. But even if jurors make correct determinations, the costs of a few physicians' mistakes is imposed on the whole population of physicians because insurers cannot tell which of the physicians are going to cause the accidents. The costs of medical accidents caused by some physicians are "internalized" for other physicians who have no accidents!

A less obvious example of misallocation may have resulted from the increase in the costs of automobile insurance for urban populations. If all urban drivers were equally dangerous, the reduction in automobile ownership caused by rising insurance costs would probably produce benefits proportionate to the inconvenience of reduced access to automobiles. But the elevated costs are probably caused by only a few drivers, while safe drivers are forced out of automobile ownership, or out of town, by the high costs of insurance. Inner city residents are disabled from taking jobs in suburbs because they cannot afford cars to take them there. Public transportation systems do not fill the gap because contemporary metropolitan areas are too widely dispersed to support such systems.55

In these situations, resource allocation through tort liability is attractive only if one forgets who pays the price. At best, many innocents are forced to contribute to a system that is unlikely to benefit them; at worst, they are excluded by zooming prices from access to the medical services or transportation that they need.

One can imagine some situations in which tort law might effectuate efficient allocations. A rule that made automobile manufacturers liable for injuries resulting from the lack of a seat belt would probably reduce injuries efficiently. All manufacturers would install seat belts, and injuries would be reduced. Although some of the involuntary purchasers of seat belts would never need them, their forced contribution to safety would not be great enough to price them out of the car market.

Steven Shavell envisioned an example of efficient allocation through liability by imagining an electric utility that is deterred

55. Calabresi, supra note 8, at 78-79, recognized this limitation on the benefits of resource allocation through liability.
from building a nuclear plant by the cost of liability insurance, which would reflect the "full expected losses." This is a valid example on the assumption that insurers are able to estimate accurately the risks of particular plants.

Such clear-cut examples seem rare. Liability of municipalities for allowing ice to accumulate in streets, for example, may impel expenditures that are out of proportion to the benefits conferred at the expense of other municipal activities. Determining how much should be spent on street clearance requires a correct calculation of the relative advantages of lower speed limits, stricter control of driving licenses, and requiring manufacturers to equip cars with self-adjusting brakes. As a recent writer observed, "The principal theoretical advantage of liability rules—internalizing externalities by compensating victims—is lost in the real world of unobservable pathways between industrial activity and harm."

Allocative efficiency is least likely to result from liabilities for injuries that are caused by different actors at radically different frequencies. Since insurers cannot predict which individuals or which circumstances will give rise to injuries, laying the costs of liability on a whole area of activity, like motoring or health care, is likely to deter as much behavior that is useful as behavior that is harmful. Although tort law promotes some efficient allocations of resources, it also has a propensity to promote misallocations. Resource allocation furnishes no reason for funneling injury compensation through tort law rather than through less expensive regimes.

CONCLUSION

Among many admirable discussions of injury compensation through tort law, there remains a pervasive lack of attention to its effects on the individual humans who ultimately contribute to its costs. When we consider these effects, we recognize that it imposes burdens on innocent individuals that are greater in the aggregate
than the benefits that it delivers to injury victims. In order to strike an efficient balance between benefits and burdens, we should give as much attention to minimizing the forced contributions of the innocent as we give to relieving distress and to motivating reduction of injuries.

I have suggested a few specific changes that might achieve these objectives. Pay for pain should be outlawed, although pain could be considered in deciding how high incentive damages should be set to induce care. Damages that are assessed for incentive purposes should be excluded from insurance and indemnification. Damages of all kinds should be made harder to pass on by disallowing the deduction from taxable income of damage payments and of premiums paid to insure against damage payments.

In order to apply intelligently the rules of liability, including the suggested changes, jurors and judges need to be made aware of who pays in the end for compensation. Attorneys should be not only free, but duty-bound, to tell decisionmakers that the resources of men, women, and children will be eventually diminished in order to pay the damages awarded.

But we should not expect judges or legislators to hack their way through the thicket of tort theory to formulate better rules. Improvement of the law is peculiarly the responsibility of scholars like those assembled in this symposium. We bear a unique responsibility for designing rules that would relieve distress and motivate accident reduction at the least cost to those who ultimately bear the burden.