Joint Economic Committee Republicans
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Improving the American Legal System: The Economic Benefits of Tort Reform

Executive Summary

The economic and legal condition of America's contemporary tort system has come under increasing criticism for being far too costly and incapable of administering fair and prompt awards. A recent actuarial study by Tillinghast-Towers Perrin indicates that tort costs rose from $67 billion in 1984 to $152 billion in 1994, an increase of 125 percent. Increased litigation costs have burdened American families and businesses with higher auto insurance premiums, reduced incentives for auto safety features, and contributed to higher medical costs. In addition, plaintiffs are often forced to accept a 33 percent toll just to have access to the current American tort system.

The economic effects of such a huge tort burden on the American economy are hard to measure directly, but are nonetheless significant. Individuals suffer from the high price of insurance and the increased cost of goods and services. Businesses are hurt by the higher prices they must charge to pay their insurance costs. The overall economy also suffers when productivity and growth are slowed by excessive litigation, which discourages risk-taking and slows the introduction of new products and technologies.

University of Virginia law professor Jeffrey O'Connell and Michael Horowitz of the Hudson Institute have assembled a tort reform proposal that would eliminate these perverse incentives and result in tremendous economic savings for all Americans.

- The "auto-choice" reform would make available $40 billion in savings on auto insurance premiums. Individuals could save $31.7 billion and businesses could save $8.3 billion in 1996 premiums. For the typical car insurance premium, this would translate into average savings of $221. In high insurance states, such as New Jersey, the savings would average $395 per premium.
- Low-income drivers would particularly benefit, since the auto-choice reform is highly progressive. While the average driver would save 28.6 percent, low-income drivers would save 44.9 percent on their premiums. Moreover, the savings from auto-choice would be enough to offset 61.7 percent of the average tax burden of the poorest fifth of American families.
- The contingency fee reform (co-authored by Professor Lester Brickman of the Cardozo Law School) would significantly reduce the total estimated cost of attorney fees of $45 billion each year. Payments to plaintiffs attorneys would reflect the value they add to their client's settlement.
- The Moore-Gephardt reform would also provide substantial savings in health care costs, through the elimination of the collateral source rule and by reducing inflated claims of medical damages. Moreover, the Moore-Gephardt reform would reduce the occurrence and size of "pain and suffering" damage awards.

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Improving the American Legal System: The Economic Benefits of Tort Reform

I. Introduction

The legal system in the United States has been widely criticized for being too costly, inefficient and ineffective in administering fair awards. In particular, the contemporary tort[1] system in the U.S. has deteriorated because of perverse incentives that lead to skyrocketing costs. Because of our current third party insurance system, and its pain and suffering damage recoveries that sustain contingency fee litigation, perverse incentives and standards have developed that drive up the cost of the tort system. In the auto insurance field, these incentives have produced a system riddled with fraud and abuse, and along with the tort system as a whole, they have generated costly, unnecessary and fraudulent medical claims. All of these problems add up to a huge economic burden for individuals, businesses, and government. According to a recent study by the actuarial firm Tillinghast-Towers Perrin, 1994 tort costs are up 125 percent from the 1984 level.

The economic consequences of such heavy tort costs are considerable. First, individuals suffer directly by having less disposable income than they would otherwise due to higher premiums for automobile and other forms of insurance. Second, individuals suffer indirectly when businesses, forced to pay higher premiums for product liability and other forms of insurance, raise their prices on goods and services. Third, when businesses have to charge higher prices, they do less business than they would otherwise, which in turn slows down job expansion and economic growth. Individuals bear the brunt of this economic slowdown in the form of lower wages and fewer jobs. Finally, increasing litigiousness discourages businesses and individuals from taking risks, which means that fewer new products are brought to market and new technologies are either delayed or forgone altogether.[2]

Individuals living and working in urban areas are particularly affected by the high costs of the tort system, because cities and other densely-populated areas have experienced an even greater increase in the tort costs. In New York City, for instance, municipal litigation costs increased 187 percent between 1984 and 1994, and such costs are increasing at a 12 percent annual rate thus far in the 1990s.[3] In addition, municipal residents pay relatively more in auto insurance and other tort-related costs, thereby adding to the economic burdens of urban residents. In the current environment of fiscal responsibility and taxpayer flight from cities, urban governments and residents can ill-afford to allocate large portions of their budgets to litigation costs.

One of the driving forces behind tort costs is insurance fraud and exaggeration. To gauge the extent to which claims of outright fraud are responsible for rapid increases in health and auto insurance premiums, the Federal Bureau of Investigation (FBI) began an investigation of staged automobile accidents. The results of this inquiry led FBI Director Louis Freeh to estimate that "[e]very American household is burdened with more than $200 annually in additional insurance premiums to make up for this type of fraud."[4]

This report examines three reforms to the U.S. tort system now under consideration in Congress. One proposal is targeted at the automobile tort system, while the other two consist of general tort reform. The three reforms are:

- Auto-Choice Reform
- Early Offer: Contingency Fee Reform
- Early Offer: Moore-Gephardt Reform

Each of these reforms addresses a different aspect of the legal system and the problem of burdensome tort costs. Each establishes procedural mechanisms which have a relatively limited effect on existing state substantive tort law doctrines. In addition, under the terms of the proposed legislation now being drafted, states retain the right to opt out of any of the above reforms.

II. Automobile Insurance: The Impact of Auto-Choice

A prime example of the burden of numerous and expensive tort cases is the automobile insurance industry. Everyone who owns a car probably has some experience with outrageous premiums for car insurance, but low-income drivers especially suffer because they have much less disposable income (a point discussed in greater detail below). Industry data indicate that the cost of bodily injury premiums increased 150 percent in the 1980s, and premiums for bodily injury coverage in 1990 were 2.5 times the level in 1980.[5] Moreover, this increase has occurred as cars have become safer and the number of automobile accidents has sharply declined.[6] A large part of the cost for automobile insurance goes to pay for tort cases. Insurance carriers simply take their tort costs, and apportion some amount to each premium. This way, everyone who insures a car pays for tort costs and system-induced fraud. Thus, as tort costs continue to skyrocket, all drivers pay the price through higher automobile insurance premiums.

One of the central flaws in the tort insurance market is the perverse incentive structure created by ever-increasing awards for pain and suffering damages. Cornell University Law Professor Charles Wolfram notes that "[p]ain and suffering and similar nonmonetary damages probably average three times the monetary damages in personal injury claims."[7] In other words, for every $1 in claimed damages, another $3 is awarded for pain and suffering damages. The historical development of this practice is complex in its origins, but this legal structure quite obviously presents an enormous financial incentive to inflate economic and medical damages.

The existence of incentives to inflate medical damages is evident in the experience of several no-fault insurance states. Hawaii and Massachusetts, for instance, have attempted to correct the perverse incentives noted by Wolfram by establishing medical/economic damage "thresholds." In

order to recover pain and suffering damages, individuals must have medical/ economic damages above this threshold. However, rather than exclude minor cases, the threshold mechanism induces many claimants to inflate medical claims through additional, and often unnecessary, visits to the doctor in order to reach the threshold. After Massachusetts raised its tort threshold from $500 to $2,000 in 1988, the median number of treatment visits rose from 13 to 30 per auto injury claim.[8] In Hawaii, where the threshold was $7,000, the median number of visits to chiropractors was 58 per claimed injury.[9]

In order to remedy the problem of burdensome tort costs and mounting fraud in car insurance premiums, Michael Horowitz of the Hudson Institute and Jeffrey O'Connell of the University of Virginia Law School have proposed a system commonly referred to as "auto-choice."[10] Simply stated, auto-choice unbundles the premium for economic losses[11] and for pain and suffering[12] losses. In addition, automobile insurance would be primarily shifted to a first party basis, where each driver's own insurance pays for his or her damages.

Under the proposed system of auto-choice, individuals would have a choice between two general types of policies. On the one hand, individuals could opt to retain the same basic rights they now have under existing state law by purchasing "tort maintenance" coverage (TM). With TM, drivers recover damages, both economic and pain and suffering, from their own insurance carrier up to the limits of their policy based on who was at fault in the accident. However, if economic damages exceed that limit, then injured parties can sue negligent drivers for economic damages in amounts that exceed their own insurance coverage. In all cases, each state's definition of economic damages, as well as each state's existing negligence law doctrines, would remain mostly unchanged.

Pain and suffering would be recovered exclusively on a first party basis. This change means that rather than suing other parties (even when they are negligent) for pain and suffering damages, TM insurers recover such damages from their own insurance carrier. The limit on recoveries for pain and suffering, therefore, is determined by the policy each individual purchases. Even in TM cases, however, when injuries are inflicted either intentionally or as the result of drug or alcohol abuse, the injured parties can sue the parties who inflicted the damages for pain and suffering, as well as economic, damages without limit. Thus, TM individuals can utilize existing state laws in order to recover all economic damages, and they can purchase pain and suffering coverages in amounts they themselves determine.

Alternatively, individuals could opt out of the pain and suffering regime altogether by purchasing "personal injury protection" (PIP), which provides insurance coverage for economic damages only. PIP drivers recover from their own insurance carrier for economic damages up to the limit of their policy, without regard to whether they were negligently injured. At the same time, state negligence laws are retained under the PIP system, so that negligent PIP drivers can be sued for all economic damages that exceed their PIP coverage. However, because pain and suffering recoveries are made on a first party insurance basis only, PIP drivers cannot be sued (or for that matter, sue) for pain and suffering damages, with the important exception of injuries inflicted intentionally or as a result of drug or alcohol abuse.

As can therefore be seen, the auto-choice reform described here accomplishes two principal changes. First, pain and suffering premiums are unbundled from economic damage premiums, for those who wish to do so. Second, insurance is primarily shifted to a first party basis, particularly with respect to the recovery of pain and suffering damages. Both TM and PIP systems seek to largely preserve state negligence laws to a lesser or greater extent. TM insureds recover economic damages above their TM coverage from negligent drivers, and recover pain and suffering damages from their own insurance carrier up to the limits of their own TM policy. PIP insureds recover against their own insurance carrier for injuries above their health insurance or sick leave, irrespective of fault, but can still sue or be sued under state negligence laws for all economic damages negligently inflicted in excess of such insurance.

A noteworthy feature of auto-choice is its improvement of the auto insurance market without violating the federalist principle of governance. Auto-choice unbundles insurance for economic damages and losses for pain and suffering while preserving substantive state law for those wishing to retain it. Moreover, states are not required to participate in the auto-choice plan. Withdrawal from the auto-choice system simply requires a vote by the state legislature.

The auto-choice reform has the further appeal of improving the free market nature of the auto insurance system. The current auto insurance system functions within limits set by laws and regulations, and consequently is limited in meeting the demands of consumers. The unbundling of pain and suffering damages, however, allows suppliers to provide insurance coverage that better meets the tastes and needs of individual consumers. This change constitutes a significant improvement on the current situation in which all individuals are forced to purchases essentially the same package of services, regardless of their individual preferences and tastes.

Savings from Auto-Choice Reform

The effects of an auto-choice plan are estimated in a 1995 study by Allan Abrahamse and Stephen Carroll of the RAND Institute for Civil Justice, a nonprofit think tank.[13] The available savings for 1996, presented in Table 1, are estimates based on extrapolations of the RAND study. For the country as a whole, an auto-choice plan would make available $40.0 billion in savings. If all drivers opted for auto-choice, private passenger automobile insurance premiums would decline $31.7 billion, a savings of 28.6 percent.[14] Potential savings for commercial auto premiums run higher at 33.3 percent, yielding up to $8.3 billion.[15] In many states, such as New York and California, individual premium savings for those who switch exceed 30 percent. A state-by-state breakdown of savings is presented in Table 2.

Estimated 1996 Savings from an Auto-Choice Plan
(in billions)

	Private	Commercial	Total
Total Auto Insurance Premiums	$110.7	$25.0	$135.7
Total Available Savings if 100% Switch	$31.7	$8.3	$40.0
Savings (%)	28.6%	33.3%	NA
Savings for Low-Income Drivers	44.9%	NA	NA

Source: Abrahamse and Carroll (1995) and Joint Economic Committee calculations.

The general reduction in tort cases resulting from an auto-choice plan would, in many states, benefit even those individuals who opted to retain the ability to sue for pain and suffering, since the tort system would likely see efficiency gains. On net, however, drivers who select an insurance policy that allows them to sue for pain and suffering can expect their premiums to be unaffected or to increase slightly, less than 1 percent on average, based on extrapolations of the RAND study.

Table 2. State-by-state 1996 savings from auto-choice.						
	Total Savings* (millions)	All Private Drivers*	Low Income Drivers*	Estimated 1996 Average Premium	Average Savings*	Average Premium Under Auto-Choice
All U.S.	$40,037	28.6%	44.9%	$773	$221	$551
Alabama	$312	16.8%	31.5%	$631	$106	$525
Alaska	$37	12.1%	19.3%	$913	$110	$803
Arizona	$777	34.8%	49.4%	$878	$306	$573
Arkansas	$337	27.9%	45.9%	$691	$193	$498
California	$5,260	33.0%	50.5%	$884	$292	$592
Colorado	$672	30.6%	45.8%	$891	$273	$619
Connecticut	$987	39.2%	54.6%	$924	$362	$562
Delaware	$148	28.9%	39.7%	$874	$253	$622
Florida	$2,220	27.1%	37.6%	$668	$181	$487
Georgia	$834	20.9%	36.6%	$712	$149	$563
Hawaii	$345	40.6%	51.7%	$1,081	$439	$642
Idaho	$145	27.8%	44.8%	$578	$161	$417
Illinois	$1,393	24.2%	41.8%	$679	$164	$514
Indiana	$763	26.1%	41.9%	$620	$162	$458
Iowa	$321	24.7%	42.3%	$521	$129	$393
Kansas	$87	7.1%	12.5%	$638	$45	$593
Kentucky	$61	3.5%	5.3%	$700	$25	$675
Louisiana	$1,015	44.0%	61.8%	$927	$407	$520
Maine	$180	31.3%	49.8%	$538	$168	$370
Maryland	$1,007	34.6%	49.7%	$775	$268	$507
Massachusetts	$1,731	39.3%	52.3%	$1,093	$430	$663
Michigan	$890	15.7%	27.7%	$815	$128	$687
Minnesota	$785	31.3%	46.0%	$740	$232	$508
Mississippi	$254	21.4%	37.3%	$703	$151	$552
Missouri	$679	25.9%	42.4%	$680	$176	$504
Montana	$142	34.3%	57.4%	$653	$224	$429
Nebraska	$198	24.7%	43.1%	$607	$150	$457
Nevada	$310	35.5%	51.1%	$975	$346	$628
New Hampshire	$144	21.7%	34.8%	$685	$149	$536
New Jersey	$2,346	36.1%	53.0%	$1,093	$395	$698
New Mexico	$272	33.1%	51.2%	$870	$288	$582
New York	$3,877	35.3%	52.4%	$1,115	$393	$722
North Carolina	$1,088	30.8%	44.6%	$554	$170	$383
North Dakota	($17)	-6.1%	-11.2%	$507	($31)	$538
Ohio	$1,294	26.5%	42.3%	$577	$153	$424
Oklahoma	$428	27.8%	45.7%	$669	$186	$483
Oregon	$402	25.0%	36.5%	$659	$165	$494
Pennsylvania	$1,994	29.7%	43.2%	$744	$221	$523
Rhode Island	$156	23.3%	32.6%	$1,103	$256	$846
South Carolina	$556	30.6%	45.0%	$708	$217	$491
South Dakota	$112	34.9%	59.2%	$595	$207	$387
Tennessee	$452	19.4%	33.6%	$595	$116	$479
Texas	$2,920	32.1%	47.1%	$908	$292	$617
Utah	$217	27.7%	44.4%	$708	$196	$512
Vermont	$50	17.2%	30.1%	$601	$103	$498
Virginia	$896	29.5%	42.9%	$578	$170	$408
Washington	$951	35.4%	50.2%	$793	$281	$512
West Virginia	$334	36.3%	56.0%	$807	$293	$514
Wisconsin	$704	30.9%	50.7%	$569	$176	$393
Wyoming	$52	24.1%	45.6%	$609	$147	$462

* Assumes 100% switch. Based on state laws as of 1988.
** Low-income savings estimate for 1993 (O'Connell, et al., 1996).
Source: Abrahamse and Carroll (1995) and Joint Economic Committee calculations.

The savings presented in Tables 1 and 2 are for a single year only. Individuals, however, would continue to accrue savings as long as they opted for auto-choice. Figure 1 displays the potential savings for auto-choice over 1996-2002. Available savings rise from $40.0 billion in 1996 to $56.8 billion in 2002. For the entire period, cumulative savings amount to $336 billion. (It is worth noting that this amount is 37 percent larger than the $245 billion in the tax cuts passed as part of the *Contract with America*.)

In terms of private passenger automobile insurance, auto-choice savings would average $221 per policy premium in 1996.[16] Car insurance premiums would be reduced from a nationwide average of $773 to $551. Drivers in Massachusetts would see some of the largest savings, with average expenditures dropping $430. New York, New Jersey, Hawaii, Louisiana, and several other states would enjoy premium savings in excess of $375 on average. A state-by-state breakdown of average premium savings is presented in Table 2.

The auto-choice savings described here should be considered conservative for at least two reasons.[17] First, while the aggregate dollar amount of realized savings varies with the number of drivers, the percentage savings from an auto-choice plan is actually higher if fewer people switch.[18] Second, these estimates are conservative in that the 1996 baseline projection of auto premiums assumes that the personal injury (PI) portion of the liability premium remains at the 1993 level. This assumption, however, is conservative in that PI premiums appear to be growing faster than other components of insurance premiums. For example, individuals involved in auto accidents in 1992 were approximately 32 percent more likely to file a bodily injury claim than in 1987, even accounting for the declining accident rate.[19] In California, the occurrence of bodily injury claims has jumped from 31 per 100 accidents in 1980 to 61 per 100 accidents in 1993.[20] This study uses the PI share of liability premium for 1993, which was 74.3 percent.[21]

Benefits for Low-Income Drivers

One of the most striking features of the auto-choice plan is its progressivity. Tables 1 and 2 include estimated savings for low-income motorists. Overall, low-income drivers can expect to see a 45 percent reduction in premiums, compared to 28.6 percent for the nation as a whole.[22]

The larger discount for low-income drivers stems in part from the change to a first party insurance system, in which drivers are not obligated to purchase as much liability insurance.[23] Moreover, the portion of the premium for economic losses would be lower for low-income drivers, because they would be insuring against their own economic loss, normally defined in terms of lost wages and income. Since low-income individuals, by definition, earn less than high-income individuals, the size of the liability (i.e., lost wages and income) is smaller, and hence cheaper to insure.

Further evidence of progressive nature of auto-choice reform is available from the nationwide 1993 Consumer Expenditure Survey conducted by the Bureau of Labor Statistics (BLS).[24] As a share of income, low-income drivers spend more on vehicle insurance than drivers with higher income. The poorest fifth of all households spends approximately 3.8 percent of their income on vehicle insurance. The wealthiest fifth, by comparison, spends just 1.5 percent of their income on vehicle insurance.

A closer examination of auto insurance costs for persons in poverty is available in a study of low-income drivers in Maricopa County, Arizona.[25] According to the Maricopa County study, households below 50 percent of the poverty line spend, remarkably, almost one-third (31.6 percent) of their income on car insurance. Even households between 50 and 100 percent of the poverty line devote 13.8 percent of their income to car insurance, nearly seven times the national average of 2 percent.

Because Arizona's legal requirement to carry auto insurance is strictly enforced (unlike in many other states), many families believe they have no choice but to purchase insurance, which in turn may induce them to forgo other items in the family budget. Surveys of low-income drivers in Maricopa County show that half (50.9 percent) of all survey respondents had to put off paying for other important expenses in order to meet car insurance payments. The most common purchase that was put off was food, followed by rent or mortgage.

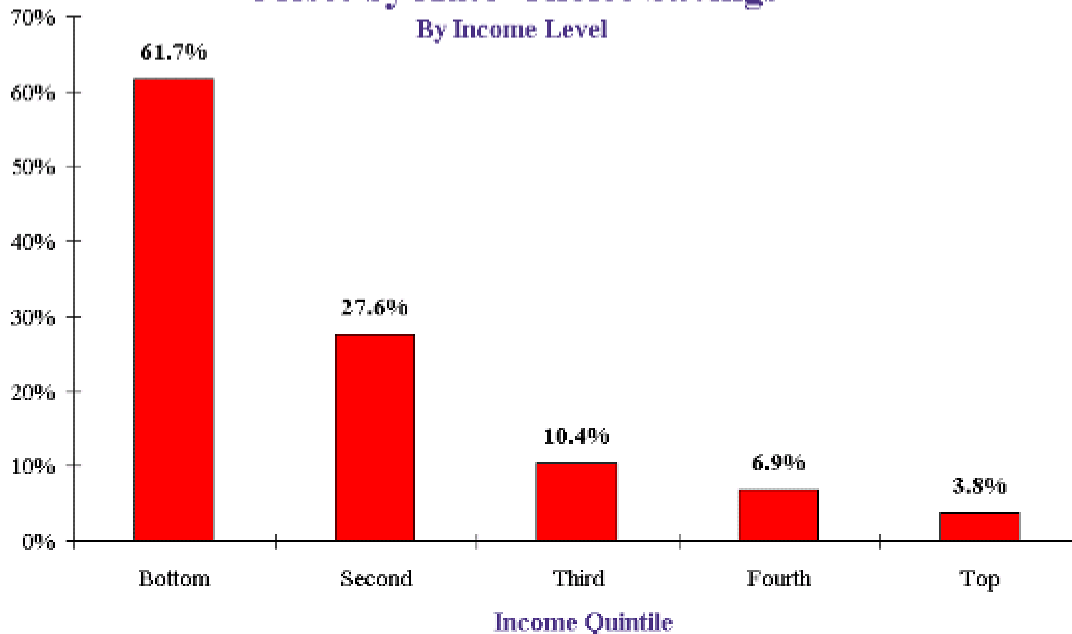
Not surprisingly, when faced with a decision between car insurance and basic necessities such as food, many drivers choose to forego car insurance, even though it means breaking the law.[26] Thus, rising tort costs ultimately compel many low-income individuals to drive uninsured, even if though it means breaking the law. The end result for drivers who remain insured is that automobile premiums are pushed higher to pay for the costs of uninsured and under-insured motorists.

Tax Equivalency of Auto-Choice Savings

Average Value	Income Quintile					All Consumer Units
	Bottom	Second	Third	Fourth	Top	
Income	$6,395	$15,071	$26,037	$41,935	$84,753	$34,868
Personal Taxes	$110	$465	$1,747	$3,503	$9,046	$2,978
Auto-Choice Savings	$68	$128	$181	$241	$346	$193
Savings Relative to Taxes	61.7%	27.6%	10.4%	6.9%	3.8%	6.5%

Source: BLS data and Joint Economic Committee calculations.

Based on the results of the Consumer Expenditure Survey, it is possible to estimate the magnitude of auto-choice savings relative to the personal tax burden (Table 3). Personal taxes, as defined in the BLS survey, include the federal income tax, state and local income taxes, and other taxes. On average, the poorest fifth of households pays $110 in total personal taxes. The average auto-choice savings of $68 for this household is equivalent to more than three-fifths (61.7 percent) of their tax burden (Figure 2).[27] The wealthiest fifth of households, by comparison, would see just 3.8 percent of their tax burden offset by the savings from an auto-choice plan.



The estimated tax equivalency of auto-choice savings should be considered conservative for two reasons. First, the percentage used to estimate auto-choice savings (in this case 28.6 percent) assumes 100 percent of drivers switch. As noted earlier, if fewer drivers switch, the percentage savings increases. Second, the percentage used to estimate savings is the average for all drivers -- 28.6 percent. As discussed above, however, a number of factors contribute to making the percentage savings for low-income drivers much higher than other drivers (45 percent versus 28.6 percent to be exact). Thus, to more accurately measure the impact of auto-choice by income level would require using a higher percentage savings for low-income groups, rather than the uniform rate used in this example.

Finally, low-income drivers are at a disadvantage in the current system due to the lengthy nature of the settlement process. By definition, low-income individuals have fewer available resources and often have pressing demands for those resources. Under the current tort regime, low-income individuals involved in an accident can ill-afford to wait out a protracted settlement negotiation. The immediate need for resources often dictates that such persons accept smaller compensation in order to achieve a quicker settlement. High-income individuals, in contrast, can afford delays in compensation for their losses. Auto-choice would work to the benefit of low-income individuals by speeding up the whole process of reaching fair settlements for damages.

Other Benefits of Auto-Choice

The benefits of an auto-choice plan are widespread and extend to a number of groups in society. First, an auto-choice plan would particularly benefit urban areas. As the RAND study documents, the savings from an auto-choice plan stem from a reduction in the personal injury

portion of liability premiums. Since liability premiums are higher in urban areas, the savings that result from an auto-choice plan are likely to be higher as well.[28] Urban areas further benefit from auto-choice because the reform would reduce the cost of living in cities relative to suburbs. Moreover, greater savings would accrue to urban areas due to their higher concentration of low-income individuals.

Second, government at all levels (federal, state, and local) would benefit from the general reduction in automobile tort costs. In addition, governments (like all employers) would save significantly on personal injury auto insurance costs, since much of their present exposure would be covered by existing workers compensation insurance. Urban governments, in particular, would benefit from auto-choice for the reasons noted in the previous paragraph.

Third, auto-choice is likely to yield significant savings in health care costs. The current tort system for automobile-related injuries presents incentives for claimants to inflate the amount of their medical damages, since every dollar of damages is repaid several times over through pain and suffering awards and the use of the collateral source rule. According to the 1995 RAND study *The Costs of Excess Medical Claims for Automobile Personal Injuries*, "excess consumption of health care in the auto arena in response to tort liability incentives accounted for about $4 billion [in 1993].".[29] The RAND study also estimates that non-economic and other losses resulting from excessive claiming behavior cost insurers another $9 to $13 billion annually.

Lastly, all drivers and consumers would benefit from increased incentives for safer vehicles.[30] The rewards for safer vehicles are relatively small currently, because under a system of third party insurance, insurance companies pay for damages incurred by the occupants of other vehicles. Thus, the fact that one of their own customers has a safer vehicle means little to the insurer, since the damage pay out depends on other automobiles and their occupants. Under a first party system, each insurance company pays for damages incurred by their own customers. Consequently, insurance companies would have a significant incentive for their customers to have safety features on their cars. Ultimately, an auto-choice plan would result in insurance companies offering greater discounts for safety features, which in turn would lead to more demand for safety features by the automobile consumer.[31]

III. General Tort Reform

The U.S. tort system is in dire need of reform, as evidenced by the growth of tort costs depicted in Figure 3. According to the actuarial firm Tillinghast-Towers Perrin, tort costs in 1994 totaled $152 billion, up 125 percent from the 1984 level of $67 billion.[32] As tort costs continue to rise, consumers and businesses bear the burden through higher prices and reduced economic production.

Excessive litigation has an adverse effect on economic growth, not only in direct costs but in the way the tort system alters individuals' behavior. One of the primary factors determining economic growth is technological innovation. To the degree that technological innovation is inhibited by the tort system (as noted above), economic growth suffers. Stephen Magee, professor of finance at the University of Texas at Austin, estimates that the excess supply of lawyers in the U.S. reduces economic output by $300 to $660 billion.[33]

Many of the problems associated with the tort system are attributable to the incentive structure exploited by lawyers as well as claimants. Lawyers, for example, currently enjoy a monopoly on access to the legal system. This monopoly allows lawyers to charge exorbitant fees, often 33 to 40 percent or more of damage awards. Claimants try to make up for these fees, in part, by inflating medical damages and seeking pain and suffering damages. As Wolfram notes, "inflated elements of general damages, such as pain and suffering, are tolerated by courts as a rough measure of the plaintiff's attorney fees."[34]

According to data from the Insurance Research Council, however, even if claimants receive a larger award due to attorney representation, they may not end up better off because of the large pay out for lawyers' fees. For instance, average net payment after fees, expenses and economic losses for claimants with a back sprain averaged nearly $500 *more* if they did not have attorney representation than if they did. Among claims for all types of bodily injury, having an attorney netted claimants just 6 percent more on average than not having an attorney (Table 4).[35]

The reforms discussed here, contingency fee and Moore-Gephardt, would address many of the flawed incentives in the current tort system. Both proposals involve early offer reforms that

establish a framework that encourages cases to be settled relatively quickly, without instituting requirements of a particular outcome or even capping the size of awards.

Average Net Payment After Fees, Expenses and Losses, With and Without Attorney Representation

	Back Sprains	All Sprains	Bone Fracture (Weight-Bearing)	All Fractures	All Injuries
Attorney	$1,051	$1,143	$2,554	$4,184	$1,608
No Attorney	$1,533	$1,326	$8,420	$6,198	$1,507
Effect of Attorney Representation	-$482	-$183	-$5,866	-$2,014	$101
Percent Difference	-46%	-16%	-230%	-48%	6%

Note: Data exclude claims for permanent total disability, claims for fatalities, and claimants with zero or missing economic loss.
Source: Insurance Research Council, 1994.

Early Offer: Contingency Fee Reform

Contingency fee is the traditional mechanism used to compensate attorneys in tort cases. Under a contingency fee arrangement, the lawyer receives a share of the damage award as payment. Typically, the lawyer's share is 33 to 40 percent of the damage award.

The problem with the contingency fee system is that in many instances, the fee paid to the lawyer is way out of proportion to the risk and effort put in on the case. For example, in cases of clear liability, a lawyer may have to commit a minimal amount of time, since the culpability of the defendant is either easy to establish or undisputed and the damages payable are readily ascertainable. This is especially true in cases where the loss exceeds the applicable liability insurance limits.

The reform, which allows contingency fee billing only when lawyers add value to settlements, would end unearned windfall fees and would make attorney compensation consistent with rules now in effect for land condemnation cases.[36] Moreover, the reform would, in the words of a leading plaintiff's attorney who supports it, give tort plaintiffs the same advantages enjoyed by corporations retaining lawyers on a contingency fee basis. As attorney Steve Susman observed in a 1993 speech to the American Bar Association (Tort and Insurance Practice Section):

> I do a lot of contingent fee work for large corporate plaintiffs and during our fee negotiations, little is left on the table. Often my clients insist on a fee structure not so different from that [reform] being proposed. So what's so awful with a rule that assures clients without clout of the same protection against a lawyer windfall?[37]

The contingency fee reform discussed here is based on a proposal by Lester Brickman, Michael Horowitz, and Jeffrey O'Connell.[38] In brief, contingency fee reform would limit the application of the contingency fee mechanism in cases where the defendant makes an offer to settle early. Specifically, defendants are given 60 days to make an early settlement offer. If the early offer is accepted, then the plaintiff's lawyer is paid based on a capped hourly rate. However, if the early offer is rejected, then a contingency fee can only be applied to awards in excess of the amount of the early offer. If there is no early offer, then the case would be unaffected by this reform.

Note that this reform differs significantly from other proposals that impose caps on plaintiffs' lawyers' fees. Under this reform, defendants are required to *earn* their advantage by making an early offer. In other words, defendants benefit from this reform only in cases where they offer to settle quickly. This stands in contrast to the standard cap proposals that grant benefits to defendants without requiring any early offer or concession on their part.

The strength of this proposal is that it establishes a framework for quick and fair settlements without imposing many restrictions or limits. Defendants are not required to make an early offer, and plaintiffs are not required to accept an early offer or other concession. Moreover, there is no limit on the amount of awards, not even for pain and suffering damages. The only aspect of the legal system that is altered by contingency fee reform is the manner in which lawyers are compensated. In addition, payments to claimants' lawyers would be based on value-adding services. Contingency fee payments, for example, would be limited to amounts that the claimants' lawyer actually obtains from defendants beyond the amount of the early offer.

As importantly, the reform would radically reduce the incentives for defendants to use their attorneys to adopt intransigent positions and engage in lengthy pre-trial maneuvers as a means of pressuring the plaintiffs' lawyers to settle on less than optimal terms.[39] Because the size of a contingency fee payment is not directly related to the number of hours worked by the plaintiffs' attorneys, such delaying strategies by defendants reduce the average hourly compensation of plaintiffs attorneys who are unwilling to settle on the defendants' terms. Contingency fee reform would help reduce the current incentive in some cases for plaintiffs lawyers to "sell out" their clients by accepting a smaller settlement which consumes little time, in order to maximize their hourly wage rate.

Ironically, the contingency fee reform discussed here embodies one of the principles set forth by the Association of Trial Lawyers of America (ATLA), a long-standing champion of unrestrained lawyers' fees. One of the professional ethics resolutions of the ATLA recommends that lawyers should "exercise sound judgement in using a percentage in the contingent fee contract that is commensurate with the risk, cost, and effort required. . . [and to] discuss with their clients alternate fee arrangements."[40] This resolution notwithstanding, the conventional application of contingency fee utilizes "a standard rate that seldom varies with the size of a likely settlement or the odds of prevailing in court."[41]

Early Offer: Moore-Gephardt Reform

A second reform to help control tort costs is an early offer reform commonly referred to as the Moore-Gephardt approach, named for a 1985 bill sponsored by U.S. Representatives Henson

Moore (R-LA) and Dick Gephardt (D-MO) that originally applied only to defined medical malpractice cases. The modern incarnation of the Moore-Gephardt reform is a more moderate but broader version introduced as bill S.300 in the U.S. Senate by Sens. Mitch McConnell (R-KY) and Spencer Abraham (R-MI). This version is in the process of being further refined. The thrust of the Moore-Gephardt reform is to encourage defendants to make early settlement offers to pay for all economic damages, and to make pain and suffering awards more difficult to obtain.

The framework of the Moore-Gephardt reform is as follows: If the defendant agrees to pay for all economic damages (as defined by state law) and reasonable attorneys' fees, then that defendant is liable only for economic damages, and not for non-economic claims. Plaintiffs have the right to refuse such an early offer, but if they do so, it becomes harder to prove pain and suffering or punitive damages. In such a case, the McConnell-Abraham version of Moore-Gephardt requires the victim to provide clear and convincing evidence of wanton or intentional defendant misconduct in order to recover non-economic damages.[42]

The ultimate impact of the Moore-Gephardt reform would be to settle many cases before any action is taken in court. Victims, however, would still be compensated for their actual losses. The removal of pain and suffering damages recognizes that to a substantial extent, such damages have developed and increased in awards as a way to pay the huge contingency fees of plaintiffs' attorneys.[43] In other words, to make sure victims receive the full amount of their economic damage awards, courts in effect add on pain and suffering damages as the lawyers' compensation. Under the Moore-Gephardt reform, however, these additional damage awards would no longer be a part of the tort system in cases where defendants offer, unconditionally, to make injured parties whole, including providing for reasonable attorneys' fees.

As distinguished from the original Moore-Gephardt proposal, the reform discussed here recognizes that in some cases where claimants have limited economic damages (e.g., children and the elderly), it may be inappropriate to let negligent defendants escape any or significant payment. Whereas Moore-Gephardt simply extinguishes pain and suffering awards, the McConnell-Abraham approach authorizes states to establish minimum payments for serious injuries. Thus, in such cases this reform would encourage early offers of substantial amounts even to those claimants whose economic damages (as defined under conventional economic damages doctrine) would not necessarily warrant such amounts.

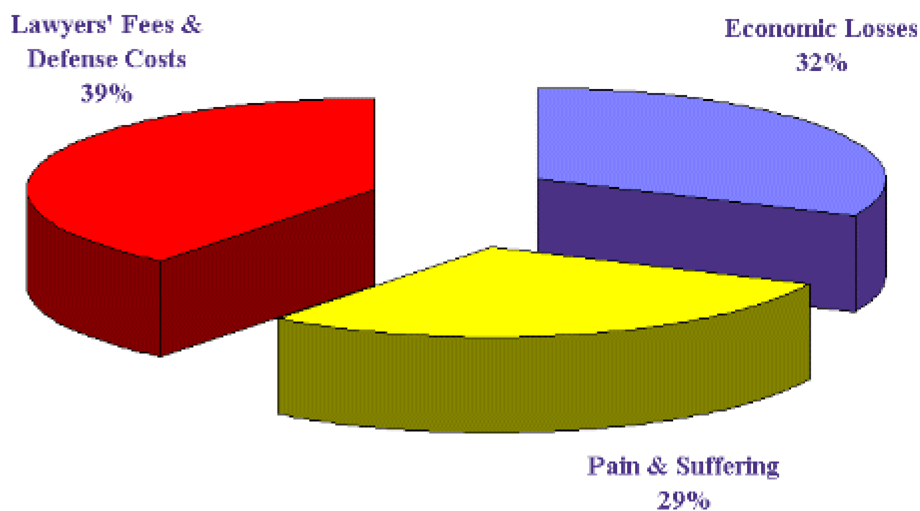
The reform would have great value for hard hit municipalities. As indicated earlier, tort costs for the City of New York are skyrocketing, more than doubling in the past seven years (1987-94).[44] In a letter to the *New York Times*, New York City Corporation Counsel Paul Crotty condemned the "litigation lottery" in which cities are currently engaged.[45] Crotty specifically endorsed the Moore-Gephardt reform, stating that it would "encourage early settlements, limit windfall payments and put money into the hands of plaintiffs shortly after their injury." In addition to direct settlement costs, urban areas would benefit significantly from reducing the processing time involved in tort cases, in terms of both efficiency and taxpayer cost of judicial administration. Whereas tort cases in large counties average over a year and a half in length (and medical malpractice cases average more than two years)[46] , the Moore-Gephardt reform would encourage many cases to be settled in a matter of weeks.

The Moore-Gephardt reform addresses one of the central weaknesses of the current tort system: the incentive to inflate damages in order to recover a larger award. This incentive stems in part from the fact that, as noted earlier, pain and suffering damages often average three times economic damages in personal injury claims. This legal structure quite obviously presents an enormous financial incentive to inflate economic and medical damages. The Moore-Gephardt reform reduces this incentive by creating a legal framework that encourages tort cases to be resolved quickly when the defendant comes forward with an early offer to make injured parties whole for all medical costs, lost wages, and other state-defined economic injuries. Only when such an offer is made does Moore-Gephardt make the recovery of pain and suffering damages more difficult to obtain.

Savings from Tort Reform

The contingency fee and Moore-Gephardt reforms described here have the potential to substantially reduce tort costs in the U.S. Both these early offer proposals generate savings from one of the most expensive costs associated with tort cases: lawyers' fees. The Moore-Gephardt reform also produces direct savings on pain and suffering damages. Just one-third of private tort costs are in the form of damages from economic losses (Figure 4).[47] Fully 68 cents on every dollar of private tort costs are attributable to payments to lawyers or to pain and suffering (non-economic) awards.

Distribution of Private Tort Costs



Source: Tellinghast-Towers Perrin and Joint Economic Committee calculation

The premise of the contingency fee and Moore-Gephardt reforms is that it is costly, indefensibly wrong, and perhaps even unethical, for lawyers to enjoy unearned, windfall profits by virtue of their monopoly control of access to the tort system. Rather than reduce claimants'

rights (such as by capping damage awards), these proposals address the reform agenda from an almost reverse perspective. The focus is less a question of whether a particular damage award or verdict is fair, and more on the question of why a surgical tragedy, arguably created by a physician's mistake, should make lawyers rich when they assume little or no risk.

The Moore-Gephardt reform is likely to have a significant impact in many areas, including medical malpractice cases, where clear negligence exists in a significant portion of claims. A 1992 study of medical malpractice claims found that in 25 percent of cases, physician care was categorized as "indefensible."[48] In these "indefensible" cases, plaintiffs received payment 91 percent of the time. It is exactly cases such as these that Moore-Gephardt would help settle quickly, since the defendant would be motivated to seek a quick resolution to the near inevitable outcome of a favorable settlement for the plaintiff.

Neither of the two early offer reforms would affect awards for economic losses (except to the extent that the McConnell-Abraham proposal authorizes states to establish minimum payments in cases of severe injury). All of the savings that would be generated by these reforms derive from other sources. A more detailed description of savings resulting from these proposals follows.

- *Lawyers' fees*: Savings on payments to lawyers result for two reasons. First, these proposals would discourage many frivolous defenses as well as claims -- for example, if claimants' lawyers know that an early offer by the defendant could reduce the claimants' lawyers' fees. Second, under Moore-Gephardt in cases where there is little dispute of economic damages, lawyers' fees on both sides would be significantly reduced. As to defense lawyers, the reform would extinguish the incentive of defendants in some cases to wear down the plaintiff through extensive legal proceedings. Alternatively, plaintiffs' attorneys would receive substantive contingency fee payments only when their efforts add value to the defendant's early offer. It is likely that a significant portion of the over $45 billion in tort costs attributable to lawyers' fees could be reduced by these proposals.[49]
- *Pain and suffering awards*: The Moore-Gephardt reform does not cap or even necessarily eliminate pain and suffering awards. Rather, Moore-Gephardt encourages cases to be settled quickly based on the economic damages to the claimant. Nonetheless, there is room for considerable savings without having to deny such damages in cases stemming from egregious misconduct.
- *Administration*: Although most tort cases are settled out of court anyway, the early offer reforms would significantly speed up the process. With tort cases often lasting years before a settlement is reached or a final verdict is handed down, early offer reforms are one of the best ways to reduce the delays and attendant administrative costs of the tort system.
- *Health care*: Health care savings result from two sources. The first source of savings is the elimination of the collateral source rule, a change which would reduce the double payment of wage loss and medical bills. The second source of savings comes from changing the claiming behavior of accident victims. Without the incentive of $3 in awards for each $1 in medical costs, consumption of unnecessary medical services would be drastically reduced under Moore-Gephardt.

In addition to these benefits, it should be noted that quick settlement of tort cases is of particular interest to low-income individuals. Protracted disputes and litigation tend to hurt low-income claimants

more than individuals with higher incomes, since the former rarely have the resources necessary to "hold out" for the appropriate compensation award.

The above discussion indicates that the savings from the two early offer reforms could be substantial. Unfortunately, the lack of data on tort costs, as well as the highly-qualitative and widely-varying nature of tort cases, precludes a reliable point estimate of savings that would result from these reforms. However, if these reforms generated even 10 percent savings, the tort system would cost $15 billion less. If savings were greater than 10 percent, an entirely plausible result of these reforms, then savings could be even higher. This finding is consistent with the research of Brickman, Horowitz and O'Connell, who estimate that the contingency fee reform alone would generate savings of approximately $7.5 to 10 billion.[50]

IV. Conclusion

As a result of the three different reforms discussed above, hundreds of billions of dollars could be saved over the next seven years. As importantly, the reforms have the potential to improve the overall quality of the American legal system. Not only would the three reforms offer injured parties more choices in seeking redress, but rewards would be administered more efficiently and fairly.

Low-income families and individuals would especially benefit in terms of increased disposable income. The auto-choice reform, in particular, would provide significant relief, in effect offsetting 62 percent of personal taxes paid by the poorest fifth of American families. In addition, by making car insurance more affordable, auto-choice would reduce the number of uninsured drivers. Moreover, the contingency fee and Moore-Gephardt reforms would favor claimants who are less able to sustain protracted legal disputes by speeding up the settlement process.

Urban areas would also benefit significantly from these reforms. City governments would be relieved of a substantial portion of their litigation expenses as the growth of tort costs is slowed. Since urban areas are characterized by a greater rate of injury claims, individuals and businesses therein would save from reductions in claiming fraud and exaggeration. These improvements, in turn, would help protect urban tax bases by reducing some of the incentives, such as prohibitive insurance rates, that have caused many individuals to flee urban cities for the suburbs.

The value of these reforms goes beyond mere dollar savings. In all likelihood, lives would be saved as a restructured auto insurance system would encourage the production of safer vehicles. All individuals who switched to auto-choice would likely see further insurance discounts for driving safer vehicles. More generally, these reforms would help correct the current system's tendency to discourage the introduction of new products and technologies.

As indicated, these proposals would generate highly progressive savings, lower unacceptably high transaction costs, enhance the rights and choices available to injured parties, and eliminate the incentives for fraud and misconduct that permeate today's tort system. For these reasons, one of the greatest virtues of these proposals is their potential to reestablish the esteem in which many Americans hold the legal system. As the tort system affects all Americans in both direct

and indirect ways, tort reform can play a critically-needed role in halting the precipitous, if understandable, decline in respect for the U.S. legal system.[51]

This analysis was prepared by Dan Miller, staff economist, and Joseph L. Engelhard, counsel to the Vice-Chairman.

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Endnotes

1. The term "tort" broadly refers to any legal case (other than breach of contract) in which injuries are inflicted by the defendant. In legal terms, a tort is a breach of a legal duty resulting in damages to another party.

2. In a 1985 study, Peter Huber documented how the attentions of the tort system are disproportionately fixed on new technologies and products, thereby leading to his conclusion that "life has grown safer not because of the legal system but despite it." Peter Huber, "Safety and the Second Best: The Hazards of Public Risk Management in the Courts," *Columbia Law Review* 85 (March 1985): 336.

3. Office of the Comptroller, City of New York, *FY 1994 Report on Claims: The "Deep Pocket"* (New York, 1995).

4. U.S. Department of Justice, Federal Bureau of Investigation, Press release (Washington, DC, May 24, 1995), 3.

5. RAND Institute for Civil Justice, *Facts and Trends* 2, no. 3 (Summer 1994): 1.

6. Insurance Research Council, *Auto Injuries: Claiming Behavior and Its Impact on Insurance Costs* (Oakbrook, IL, 1994), 1; and O'Connell et al., "Consumer Choice in the Auto Insurance Market," *Maryland Law Review* 52, no. 4 (1993): 1022-23.

7. Charles Wolfram, *Modern Legal Ethics* (St. Paul, MN: West Publishing Co., 1986), 528 at note 21.

8. Sarah Marter and Herbert Weisberg, "Medical Expenses and the Massachusetts Automobile Tort Reform Law: A First Review of 1989 Bodily Injury Liability Claims," *Journal of Insurance Regulation* 10, no. 4 (Summer 1992): 488.

9. Insurance Research Council, *Automobile Claims in Hawaii* (Oakbrook, IL, 1991), 26.

10. The proposal by Horowitz and O'Connell is more fully described in a series of three articles using cost estimates prepared by RAND. See: O'Connell et al., "The Comparative Costs of Allowing Consumer Choice for Auto Insurance in All Fifty States," *Maryland Law Review*, forthcoming, 1996; O'Connell et al., "The Costs of Consumer Choice for Auto Insurance in States without No-Fault Insurance," *Maryland Law Review* 54, no. 2 (1995): 281-351; and O'Connell et al. (1993).

11. Economic damages are defined differently in each state, but generally refer to direct measurable losses such as medical expenses, lost wages and income, funeral expenses, legal costs, and property damage.

12. The term "pain and suffering" is loosely used to refer to all non-economic damages, such as stress, emotional pain, and other psychic damages.

13. The RAND study estimates the effect of auto-choice based on laws in effect as of 1988. Laws in some states have changed since 1988, potentially affecting the savings estimated by Abrahamse and Carroll. Allan Abrahamse and Stephen Carroll, *The Effects of a Choice Auto Insurance Plan on Insurance Costs* (Santa Monica, CA: RAND Institute for Civil Justice, 1995), 26-7.

14. The 28.6 percent savings figure assumes 100 percent of drivers switch to an auto-choice plan. If fewer drivers were to switch, the percent savings actually rises slightly. Based on the RAND study, if 50 percent of drivers switch, the percent savings on premiums increases to 31.9 percent for those who switch. For an explanation, see O'Connell et al. (1996), note 86.

15. If 50 percent of commercial drivers switch, the savings percentage increases to 37.1 percent. For an explanation, see *supra* note 14. In addition, since businesses already have workers compensation insurance to cover personal injuries, the percent savings for commercial policies is likely to be even higher than indicated in Table 1.

16. The term average premium refers to the average premium cost for the typical auto insurance policy. Actual policies vary significantly in terms of the type and number of vehicles, type and number of drivers, and other factors. Estimates for 1996 are Joint Economic Committee calculations based on data from National Association of Insurance Commissioners, *State Average Expenditures and Premiums for Private Automobile Insurance in 1994* (Kansas City, MO, 1996), Table 3.

17. For a further discussion of why these estimates are conservative, see O'Connell et al. (1993), 1039-40; O'Connell et al. (1995), 289; and Abrahamse and Carroll (1995), 27-38.

18. See *supra* note 14.

19. Insurance Research Council (1994), 1.

20. Insurance Research Council, "Part One: Analysis of Claim Frequency," *Trends in Auto Injury Claims*, 2nd ed., (Wheaton, IL, 1995), Table A-6.

21. The term personal injury (PI) premium refers to coverage for bodily injury, medical payments, uninsured motorists, and underinsured motorists. The 1993 PI share of liability premium is published in O'Connell et al. (1996), Table 2 (column 4).

22. The savings estimates for low-income drivers are for 1993 premiums, though it is unlikely that the savings percentage would change much for 1996. Low-income savings are RAND estimates published in O'Connell et. al. (1996), Table 3 (column 5). See also *supra* note 14.

23. In particular, drivers would not have to purchase supplementary bodily injury coverage. For a discussion, see O'Connell et al. (1993), 1040 and O'Connell et al. (1995), 289-90.

24. Http://stats.bls.gov/blshome.html.

25. Robert Lee Maril, "The Impact of Mandatory Auto Insurance Upon Low Income Residents of Maricopa County, Arizona," unpublished manuscript, 1993.

26. This phenomenon is illustrated by an editorial in the African-American newspaper *The Philadelphia Tribune*:

Because state law mandates that motor vehicle owners must have insurance to drive those vehicles and because many Philadelphians are required to pay auto insurance rates far in excess of the value of the vehicles they drive, many Philadelphians are committing a crime because they are driving without the legally required auto insurance. (October 21, 1994, 6-A)

27. Because the BLS survey data are for 1993, the estimated savings are for 1993. Thus, the figures on tax equivalency may appear slightly different from other 1996 figures used elsewhere in the paper.

28. An analysis of urban versus suburban and rural claiming patterns is presented in the Insurance Research Council, "Part One" (1995), 15-27.

29. Stephen Carroll, Allan Abrahamse and Mary Vaiana, *The Costs of Excess Medical Claims for Automobile Personal Injuries* (Santa Monica, CA: RAND Institute for Civil Justice, 1995), 23.

30. For a full discussion of the failure of command and control safety regulation, see Jerry Mashaw and David Harfst, *The Struggle for Auto-Safety* (Cambridge, MA: Harvard University Press, 1990).

31. A corollary benefit is that since auto-choice would lower overall operating costs for newer and safer cars, it seems reasonable to expect that auto-choice could eventually result in an increase in new car sales.

32. Tillinghast-Towers Perrin, *Tort Costs Trends: An International Perspective* (New York, NY, 1995), Appendix 2.

33. Stephen Magee, William Brock, and Leslie Young, *Black Hole Tariffs and Endogenous Policy Theory* (New York, NY: Cambridge University Press, 1989) 111. 34. Wolfram (1986), 528 at note 21.

35. Insurance Research Council (1994), 61.

36. Lester Brickman, Michael Horowitz, and Jeffrey O'Connell, *Rethinking Contingency Fees* (New York, NY: The Manhattan Institute, 1994) note 34.

37. Stephen D. Susman, "A Case for a Cease Fire," Address to the Annual Meeting of the Tort and Insurance Practice Section of the American Bar Association, April 15, 1994.

38. Brickman, Horowitz, and O'Connell (1994). See also: Michael Horowitz, "The Case for Fundamental Tort Reform," Hudson Institute Briefing Paper No. 176 (May, 1995); and Michael Horowitz, "Making Ethics Real, Making Ethics Work: A Proposal for Contingency Fee Reform," *Emory Law Journal* 44, no. 1 (Winter 1995): 173-211.

39. For a discussion on how the reform would affect incentives faced by defense attorneys, see Horowitz, "Making Ethics Real" (1995), 183-93.

40. Association of Trial Lawyers of America, *Keys to the Courthouse: Quick Facts on the Contingency Fee System* (1994) 13.

41. Derek Bok, *The Cost of Talent* (New York, NY: Free Press, 1993), 140.

42. This provision of McConnell-Abraham differs significantly from the original Moore-Gephardt proposal, which was much stricter. In contrast to McConnell-Abraham's "clear and convincing" evidence standard, the original Moore-Gephardt proposal required the more stringent standard of "beyond a reasonable doubt."

43. Wolfram (1986), 528 at note 21.

44. See *supra* note 3.

45. April 27, 1995.

46. U.S. Department of Justice, Bureau of Justice Statistics, *Tort Cases in Large Counties* (Special Report NCJ-153177, April, 1995), 3.

47. The term private tort costs refers to all non-administrative tort costs. Estimate is based on data from Tillinghast-Towers Perrin (1995).

48. Mark I. Taragin et al., "The Influence of Standard of Care and Severity of Injury on the Resolution of Medical Malpractice Claims," *Annals of Internal Medicine* 117, no. 9 (November 1992): 780-4.

49. Data on lawyers' fees from Tillinghast-Towers Perrin (1995), Appendix 2.

50. Brickman, Horowitz, and O'Connell (1994), 40.

51. For further discussion, see Brickman, Horowitz, and O'Connell (1994), note 77.