COMPETITIVE ENTERPRISE INSTITUTE

A NATIONAL AGENDA FOR TORT REFORM

Richard A. Epstein

James Parker Hall Distinguished Professor of Law,
University of Chicago Law School

March 1995

1001 Connecticut Avenue, NW • Suite 1250 • Washington, D.C. 20036 • Telephone: (202) 331-1010 • Fax: (202) 331-0640

A National Agenda for Tort Reform

by Richard A. Epstein

A Questionable Regime of Judicial Innovation The issue of tort reform has been on the public agenda in one forum or another for the past twenty years. That formerly obscure subject did not achieve such public notoriety simply because its fascinating intellectual issues found a ready audience with manufacturers, physicians and hospitals, and local governments. It arose because of the massive increase in both the frequency and severity of tort claims that took place, all without any apparent explicit acknowledgment that the previous system was broken and in urgent need of repair. That something is wrong with the modern liability revolution can be demonstrated, I think, by one simple general observation: the levels of accidents in most critical industries have trended downward over time, at the same rate before the massive transformation of tort doctrine as it has done afterwards. Yet the number of lawsuits has risen inexorably over most of this time, tailing off only slightly in recent years. Deterrence of accidental losses is surely thought to be one of the central aims of the legal system. By that measure the modern tort reforms should be counted as a failure, for the extra costs of litigation have done nothing to improve the overall level of safety, which are largely attributable to technological innovation, which, if anything, has been slowed down by the risk of tort reform. What we have is a system that chews up at least one dollar in litigation and administrative costs for every dollar of compensation it delivers—a ratio that no sound system of first-party insurance could long tolerate.

Errors of this magnitude cannot be explained by small causes. The burden of proof on causation or contributory negligence, the pleading requirements for a personal injury action, even the vaunted movement from negligence to strict liability in some tort areas, such as product liability, are not the source of the current malaise. Nor will matters be materially improved if these doctrinal changes are reined in by moderate state law tort reforms. The social problem here is of larger dimensions, and the root difficulty goes to the fundamental question of how the tort law is understood. The transformation of the law of tort, in my view, is traced to a theme that stood at the center of the last election: the inexorable rise of regulation and the suppression of private choice and contractual control. The regulation in many cases was introduced without the fanfare of legislation, often by judges who had a scant appreciation of the major consequences they wrought by imposing a warranty obligation or striking down a disclaimer clause. But when the dust settles it is the insistence on overtly public norms, hostile to private contracts and private

arrangements, that has fueled the modern difficulties in the tort law. A brief account of this development is critical to set the stage for the reforms that are useful and necessary at this stage.

A Capsule History of the Law of Tort It is instructive to center this account around three cases. *Henningsen v. Bloomfield Motors*, 161 A.2d 69 (N.J. 1960) held that virtually all manufacturer disclaimers of liability were suspect because of the inherent inequality of bargaining power between manufacturers and consumers. Contracts were not thought of as instruments that allowed transactions which worked to the mutual benefit of parties, but as methods for expropriation used by large corporations to extract wealth from consumers who were powerless to go elsewhere. The logic of *Henningsen* was that the relative size of the two parties was all that was relevant to any sensible judicial determination of liability. Wholly lacking was any reference to the structure of the relevant market. The court did not believe that competition is sufficient to keep product price, product quality and product warranties in line. Failing to understand the contractual drive to efficiency, the New Jersey court (and the many courts that followed it) could not understand why consumers might benefit from the limitation of liability contained in many standard form contracts. There was no hint that these agreements limiting liability could increase the level of user care, or prevent the cross-subsidization of risky consumers by safe ones.

This malaise quickly spread to other areas. In *Tunkl v. Regents of California*, 383 P.2d 441 (Cal. 1963), the court quickly applied the same anticontractual logic to a hospital's provision of medical services, noting that so long as the supplier of services has some "decisive bargaining advantage," the exemption clauses that it inserted in standard form contracts were invalid, so that the judge-made tort law controlled. Once again the court was unable to discern any advantages to regimes that contracted out of the tort system. It thought that any additions to the cost of medical services could be covered by adjustments in prices, and was utterly oblivious of the inability of institutions to raise prices to pass on the losses in question. The relentless pressure of liability inexorably leads to pressures on both the cost and the availability of services. Yet the dominant wisdom of the age assumed that markets had an infinite adaptability in the face of severe external constraints. Once again the importance of competition and the effect of market sanctions, such as reputation, were wholly overlooked.

The net effect of these two early decisions was difficult to see at first. The cases that struck down limitations on contractual freedom were not chosen at random. Lawyers looked for cases where the contract system seemed to work least well. It was just a matter of time before any system that handles thousands of products or thousands of patients generated some terrible blunders. So the courts in the beginning applied rules of tort liability that did little if any offense to common

conceptions of fairness. What is, after all, so bad about holding a defendant liable when it botched a standard procedure, or produced a product that broke down in ordinary use? But the concern with the individual cases overlooks the central institutional insight: when contracts are no longer allowed to govern liability, then there is no effective counterweight for the speculations of the judges who have no feedback mechanism which allows them to decide whether their adventures into new areas of liability are good or bad. They are not punished by the market, or by any set of government sanctions, when their innovations do nothing to advance consumer welfare. The reasons for judicial independence are too powerful to admit such sanctions.

Accordingly, often their least sound decisions generate the most business for lawyers and the greatest expansion of judicial power. It is an irony that courts, which have so little knowledge about the operation of complex economic systems, too often decide cases on the assumption that private parties lack the necessary information to make intelligent choices. Yet once an interventionist error becomes entrenched, it is very difficult to undo by judicial means. It is unlikely to find any uniformity of opinion of these important issues, so that the power of precedent makes any undoing of reform a haphazard process. And even when mistakes are recognized, as was the case with Bendectin, judicial correction comes only after a useful product has been withdrawn from the marketplace.

Henningsen and *Tunkl* show the unwarranted hostile response that courts have to contractual efforts to limit liability. But matters are still worse because the judicial doctrine is now set in ways that make it foolhardy for any firm to risk *expanding* its liability by assuming additional responsibility. Here the source of the judicial mischief is a 1974 New Jersey decision, *Collins v. Uniroyal*, 315 A.2d 16 (N.J. 1974), which shows how legal doctrines of unconscionability can destroy the incentive for firms to introduce innovative warranties to deal with questions of product safety. *Collins* involved a novel warranty offered by Uniroyal against all blowouts regardless of their cause. The warranty made it clear that Uniroyal would stand behind its product even if the plaintiff offered no proof of product defect, so long as the owner did not puncture or abuse the tire. By the terms of this warranty, Uniroyal would repair or replace the tire, but it excluded all liability for consequential damages, including damages for personal injury, attributable to the tire failure. The net effect of this warranty was to expand the scope of coverage. Without the warranty the plaintiff could recover nothing for a blow out where there was no defect. With the warranty, the plaintiff could get back the cost of the tire. No one claims that this is perfect compensation for any injury that arises. But that limited warranty does offer an important signal that the manufacturer has some confidence that the tire will perform at high levels, which allows consumers to gauge their own behavior by the manufacturer's implicit assertion that the tire performs well under adverse circumstances.

This program for expanded coverage received a dubious judicial response. The New Jersey Court accepted the expanded coverage in the basic liability that the warranty provided. But the limitation on recovery for all consequential damages was rejected as "unconscionable." The firm that thought it signalled confidence by assuming a small additional risk was told that it was now answerable for full tort damages, even where the product itself contained no defect for which the tort law could hold it responsible. From that point on any firm that offered a package of additional coverage plus damage limitations placed the corporate assets at risk. No longer would it be prudent for an automobile manufacturer to offer a promise to pay $10,000 to the estate of any person killed while wearing a seat belt in its automobile. No longer can a drug company offer a similar warranty for persons who die from side effects from a given pill. Now each loss could expose a manufacturer to losses a hundred-fold more than they had agreed to assume. What manufacturer could take even a small risk that *Collins* would be followed somewhere else? Indeed if a firm thought that other states would not distort the terms of so sensible a warranty, clever plaintiffs lawyers could steer a large number of cases to New Jersey. One application of the doctrine of unconscionability thus killed the market for innovative contractual warranties. Only ironclad statutory protection at the federal level could induce any firm to enter into the hazardous territory created by a single judicial decision.

Proposals for Reform The bottom line therefore is that legal doctrines today have blocked any flexibility in contract terms, whether they seek to expand or contract on the single rigid standard form contract fashioned by the tort law. The dangers of rigid government monopolies are not diminished when exercised by courts. The question is what can be done to eliminate the hazards in question. Here are some suggestions.

A Return to Freedom of Contract The first proposal is to reintroduce the doctrine of freedom of contract with respect to liability and disclaimers. That prospect is greeted with unalloyed horror by the established bar which trots out the time worn arguments of "imperfect information" and "inequality of bargaining power" to justify perpetuation of the status quo. When this question was considered in the drafting of the Restatement (Third) of Products Liability, section 8, (Tentative Draft #1) the response to the suggestion was both curt and uninformative: "Disclaimers and limitations of remedies by product sellers, waivers by product purchasers, and other similar contractual exculpations, oral or written, do not bar or reduce otherwise valid products liability claims for harm to persons." After all: "It is presumed that the plaintiff lacked sufficient information, bargaining power, or bargaining position necessary to execute a fair contractual limitation of rights to recover."

This observation fails to explain why a conclusive presumption of ignorance holds when prominent disclosures could overcome the gap. Similarly, it fails to explain why

inequality of bargaining power exists in competitive markets. Yet in striking down the contractual warranties and disclaimers it makes the far more heroic assumption that government officials, including judges, have better information than the participants to the transaction. The Restatement proposal here should be reversed promptly and decisively by a provision that states: "Any disclaimer or limitation of liability entered into by contract shall be fully enforceable between the parties in accordance with its terms. Any assumption of additional liability, including those which contain limitations on liability for consequential damages, shall also be enforced in accordance with its terms."

A provision of this sort will have important benefits, but it will not provide a panacea for all difficulties in this area, and its advantages should not be oversold. There are two evident limitations on the use of contractual provisions even when these are fully respected and enforced by the courts.

First, contract will not limit the liability for products that have already found their way into the marketplace. Much industrial equipment—machine tools, airplanes, automobiles, drilling equipment, chemicals—was made years ago, and a set of contractual limitations for new products would hardly work with respect to those products which have long been in the stream of commerce, but which have years of useful life (or potential danger) ahead of them. The contract situation looks forward. Many of the potential sources of liability are already out there in the field, working in factories or buried in the ground.

Second, contract is strained whenever the products in question move quickly and frequently from hand to hand. A manufacturer of an automobile or machine tool enters into a contract with its original purchaser. But the product is sold and resold until it injures a party who has no contractual connection with the original seller. Of what possible use is a contractual disclaimer to a party who has no knowledge of it? Precious little.

Yet it should not be supposed that these two difficulties render all contractual provisions useless. In fact there are several important classes of cases where contracts could work well. Thus any case where a manufacturer wishes to *expand* its liability subject to limitations on contractual damages could operate through this system. While it may be unfair to bind a stranger to a contract of whose terms he is ignorant, no similar objection applies to a manufacturer that wants its limited warranty to extend to the entire universe of present and future product users. The only real question is whether that manufacturer has made a prudent business decision, and that question can be left to the firm, without any guidance of public officials.

In addition, the contractual regime should be of great benefit in those industries where the goods and services have short half-lives and are used by the very persons to whom they are sold. Both medical services and medical products fall into that description. The patient who visits a physician needs both the drugs and services that the doctor provides for himself. There is no responsible way for these goods and services to be transferred to a third person, who has no reason to take them. There is no large backlog of drugs and medical services that will generate future liabilities (although occasional cases of this sort might be found). The recognition of contractual standards should therefore offer an immediate boost to the range of goods and services that can be offered, and a reduction in the price for those services that can be charged. To be sure, there is no reason to limit the availability of contractual provisions to these and similar industries. But there is some reason to believe that they will be most important in this particular context.

The basic return to freedom of contract could be accompanied by some other useful changes in the substantive tort law.

A Restoration of the Open and Obvious Rule If the contractual regime is incomplete three other reforms could go a long way to eliminating the central problems of the tort system as we now know it. The first of these has to do with the resurrection of "the open and obvious" defense in ordinary product liability cases. Until the 1970s, the single fact that a dangerous condition was open and obvious was sufficient to defeat any action for *either* defective designs or inadequate warnings. The basic logic of the argument was that once the condition was apparent to all, any individual consumer could decide whether the gains from the use of the product were sufficient to justify the risks that were taken. The doctrine works well with products that move quickly from hand to hand, for the dangers in question are as obvious to the subsequent purchaser as the original one, so long as the product is in its original condition. The dangers in question are as evident when the product is 50 years old as when it is one year old. And if that danger is no longer obvious, then someone else should be responsible for the post-sale alteration that the manufacturer did not make and could not prevent.

The practical limitations of contract are thus overcome, with a doctrine that requires the manufacturer to give notice of the risk to the world. Yet there are no social dangers here. No manufacturer could hope to remain in business by offering products with gratuitous risks, for consumers would flock to rival products that promised equal benefit at far lower costs. The defense therefore removed from the courts the heavy burdens of deciding whether certain designs or warnings should be improved after the fact, when it is all too easy for judges and juries to second-guess the decisions made in the field. Limiting liability to hidden traps and latent defects returns the law to an old and honorable tradition.

A second variation of the open and obvious defense—the common knowledge defense—applies to certain important classes of generic goods, of which alcohol and tobacco are the most important. In these cases, no one can deny that there may be some difference in the level of danger associated with high or low nicotine and tar cigarettes, or with 100 proof rum or 3.2 beer. But the basic danger is well known and defined by the generic risks of the product in question. While these hazards are not discoverable by direct inspection, they are typically a matter of common knowledge, and that knowledge should operate to bar any liability, whether for the original purchaser or some subsequent taker.

Oftentimes that same logic extends beyond generic products. Automobiles are all known to be subject to risk of collision, and bicycles and motorcycles even more so. In these cases the lack of particular information about the relative riskiness of this or that product is probably far less important than the overall base rate of knowledge possessed by ordinary members of the public with respect to particular products. In these cases too, an action should ordinarily be barred.

Conclusive government standards for warnings and designs The arguments about common knowledge, while strong, are not as strong as those for risks that are open and obvious to all product users. It is quite possible that the state could take the position that some additional information by way of warning should be supplied. Even that position does not necessarily entail any level of judicial or administrative regulation, because it is quite possible that many firms will voluntarily choose to warn of certain important risks because they wish to maintain their reputation in a competitive marketplace. Yet even that set of protections could be insufficient, and perhaps some degree of regulation is appropriate.

But the critical question has to do with form. To answer that question it is necessary to consider the interaction between judicial and administrative remedies. The modern administrative state will often require extensive warnings of the dangers of drugs and chemicals, and by the same token may impose detailed regulations on the key design features of machine tools, automobiles, airplanes and the like. For these purposes we can assume that this form of government intervention is wholly appropriate, and assume further that once the manufacturer or supplier fails to provide the stipulated warnings or meet the required design standards, then any person so injured by that breach of duty could recover tort damages. The critical question is what should be done in the converse situation where the manufacturer or supplier is in complete compliance with the applicable government norms.

The modern response is to allow all injured parties a second bite at the apple, whereby it can be proved that the government standards are inadequate in the case. But that Monday morning quarterbacking introduces more errors than it eliminates, because a jury (influenced by hindsight and empathy) sees the injury that was caused

but ignores the injuries that were prevented by the design or warning features. The tendency is to assume that changes in warnings and design can be made in isolation, that decisions in one case will not influence the availability of products, the rate of innovation, and the level of safety in other cases. That myopic view leads to the imposition of liability that may provide compensation in the individual case, but only at the cost of massive product and service dislocations in other cases hidden from the jury. An administrative body has to make an honest assessment of the alternative perils without having the luxury of overweighing any of them. It must decide whether adding weight to avoid one kind of collision reduces maneuverability so as to increase the risk of a second. It has to decide whether a warning that is too strong will drive away people who should use a product notwithstanding its great risks in order to avoid a greater peril. Choose the wrong set of incentives and a huge number of unnecessary law suits are filed because the administrative standards are regarded as "minimal," even though the actual pre-clearance procedures are, if anything, far too restrictive and cumbersome, as surely is the case with the FDA. Above all, this one reform could go a long way to rationalize the operation of the welfare state. And as for products that are already on the market, the reform could reduce the scope of liability in cases that a future-oriented regime of contract law could not touch.

Statutes of Repose The last point that might help with the product liability situation is a statute of repose. The General Aviation Revitalization Act of 1994 marks one recent Congressional effort to obviate the massive expansion of liability which resulted when virtually every crash of a private airplane led to a law suit against the manufacturer, no matter when the plane was made and no matter what the circumstances of the crash. One might quarrel with some of the limitations that reduce the effectiveness of the statute, but in principle there is no reason why the relief afforded should be confined to that single class of products. Any long-lived product is subject to the prospect of deterioration, of modification and alteration, of obsolescence, and of consumer misuse. In many cases the injured party will have a direct right of action against the person who is in possession of the product at the time it causes injury or death, and who is in a better position to avoid any associated loss. Damages for structural elements in buildings are better brought against the present owner than against a prior owner or a remote supplier of building components. In framing a clean outside statute of limitations, the important point here is to pick a period that is long enough so that one is confident that exculpation of a manufacturer will not create an incentive for it to produce shoddy products because it has no fear of liability, but clean and sharp enough so that once the period is passed, the liability is wiped off the books.

Loser pays. One other possible reform involves not only product liability actions, but all forms of tort matters. The American procedural system is unique in many respects. It gives the jury the largest role in determining both liability and damages,

and it adopts a system whereby each party pays its own legal expenses regardless of the outcome of the suit. In principle this second rule is subject to a strong challenge for it means that an innocent plaintiff is not fully reimbursed by a tort award, since it must still bear the costs of litigation. On the other hand, an innocent defendant does not obtain reimbursement of its legal fees when it has prevailed, so that it too is worse off than it would have been if never sued in the first place. One question is whether a rule that allows *either* prevailing party to recover its legal expenses is an appropriate reform that could help correct the imbalance that arises whenever litigation expenses are left unredressed for the prevailing party.

While in theory there is much to be said about this reform, in a practical sense some real caution is required. The loser pays approach does nothing to reform the substantive rules of the game. Where those rules are biased to the plaintiffs, then the loser pays system will encourage still more law suits and thus compound the present set of difficulties. And where the substantive reforms do make it clear that product sellers are entitled to summary judgment, then the cost rules are far less important. In addition, there is a real danger that the use of a jury will subvert the major purpose of the procedural system. The simple question is should a plaintiff be allowed to recover its full costs when it receives an award of $1? If yes, then juries may well find a way to split the difference so that the needy plaintiff is not out of pocket even though its case is weak on the merits. In order to avoid this outcome, it will be necessary to either have greater clarity in the legal rules, greater judicial supervision over jury verdicts, or a rule that allows the plaintiff to recover a percentage of its legal expenses *proportionate* to the extent of its victory. The $100 case with a $1 verdict will thus require the plaintiff to reimburse the defendant for 99 percent of its costs, assuming that we know the amount in controversy in the first place. Figuring out how to work these adjustments is a complex affair that goes far beyond tort reform. The matter is one that should be studied, but as part of a comprehensive review of civil procedure generally.

Federalism Product liability reforms need to be enacted, but where? As a basic matter, the presumption should be that the federal government has limited powers, so that legislative reform should lie within the province of the states. That approach makes good sense when the issue is the liability of local governments for negligence in the conduct of their public operations, and even for such issues as medical malpractice or occupier's liability reform. Virtually all of the relevant defendants in these cases are located within the state, where they have sufficient political muscle to work the needed transformations. But product liability reform raises very different questions. Years ago when I testified on product liability reform on behalf of the American Insurance Association before a committee of the California State Legislature, I was asked right out of the box by Jesse Unruh—the words are a paraphrase— "Professor Epstein, while I think that there is much to be said on the merits for your position, you first have to address one issue. Why should a California

legislature enact tort reform for the benefit of out-of-state producers at the expense of in-state consumers?" And the legislative package of reforms died right then. The same point has been taken up by judges when the discussion turns to judicial reform of the tort system. Judge Richard Neely of West Virginia, for example, made the same point with commendable bluntness in *Blankenship v. General Motors* Corp., 406 S.E.2d 781, 783 (W.Va. 1991):

> West Virginia is a small rural state with .66 percent of the population of the United States. Although some members of this court have reservations about the wisdom of many aspects of the tort law, as a court we are utterly powerless to make the *overall* tort system for cases arising in interstate commerce more rational: Nothing that we do will have any impact whatsoever on the set of economic trade-offs that occur in the *national* economy. And, ironically, trying unilaterally to make the American tort system more rational through being uniquely responsible in West Virginia will only punish our residents severely without, in any regard, improving the system for anyone else.

An inexorable set of pressures leads to this unfortunate situation. In an integrated economy most manufacturers who are sued come from out of state and most consumers who are injured come from in-state. The local calculation therefore is that it is fine that $2X be paid from out of state to produce $X of in-state benefits, where the loss comes from the familiar combination of high administrative costs and the inferior incentives for innovation and safety. If that self-interested calculation is repeated in state after state, then summing over all states we produce a world with $50X in gains and $100X in losses, where the citizens of *all* states lose on average. There is an unfortunate race toward the bottom which will not be corrected by legislation so long as no answer is forthcoming to either Unruh or Neely.

Federal legislation brings all the gains and all the losses under the same tent so that there are powerful incentives at work to correct the systematic skewed effect that comes when state legislatures and courts are driven by local considerations to make decisions that bind national markets. At the very least therefore there can be no practical objection to any reforms that afford conclusive weight to statutory rules and regulations that are promulgated by federal regulation, and the willingness of Congress to pass a statute of repose for airplanes offers a strong precedent for passing a similar statute for all other products. In addition, the tangled choice of law questions that arise now when products are routinely designed, made, marketed and sold across several states are sufficiently intractable that a uniform federal standard that guaranteed the nationwide enforceability of these provisions seems to be called for as well. The gains from responsible federal legislation seem tangible,

and these are sufficient in my judgment to overcome the usual presumption against federal encroachment in traditional state issues, especially since any sensible reform is designed to achieve the desirable result of less law in an area that has suffered too long from massive overregulation.

Conclusion The range of substantive tort reforms might be thought to reduce the level of recovery for injuries, and so in many cases it will. But the full picture in fact is far more complex than this simple criticism might presuppose. In those cases in which the liabilities currently imposed are onerous, firms have other ways to protect themselves. One option is to liquidate and to distribute assets. A second is to lodge all dangerous innovations in small corporations whose limited liability works to eliminate recovery in fact no matter what is provided for by law. Still a third is to studiously refrain from expanding its warranty protection voluntarily. The need for product liability reform should not be understood as an effort to benefit producers at the expense of consumers. Instead the long view, which starts at research and sale, should lead us to a very different understanding. A sensible set of liability rules works for the long term interests of consumers by rationalizing risk, by inducing the sale of risky but beneficial products and services, and by lowering costs in ways that expand access. We cannot measure the success of a product liability system by looking at the level of compensation that it gives to injured persons once injury has occurred. We have to look at that system in terms of its overall impact on safety and well being. And it is just on this score that the modern system of liability fails and stands in need of immediate reform. Judges and legislators know less about consumer welfare than consumers themselves. And it is by the standard of consumer welfare that these product liability reforms should be judged.

ABOUT THE AUTHOR

Professor Richard Epstein is a prominent legal scholar who has written on a vast range of legal topics. Among his books are *Takings: Private Property Under the Power of Eminent Domain*, *Forbidden Grounds: The Case Against Employment Discrimination Laws*, and *Bargaining with the State*.