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DEREGULATING INSURANCE SUBROGATION:
TOWARDS AN EX ANTE MARKET
IN TORT CLAIMS

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Discussion Paper No. 395

12/2002

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Cambridge, MA 02138

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Abstract

This essay analyzes the benefits of a tort system in which commercial and governmental first-party insurers acquire complete ownership and control over the prosecution and proceeds of their insureds' prospective tort claims. Under the regime of unlimited subrogation ("US"), insurers would treat tortious injury like any other covered risk thus paying an insured only for pecuniary loss (e.g., medical costs, lost income, etc.) according to standard policy (or program) terms. In return, insureds would receive payment in the form of reduced premiums (or taxes) or other financial benefits, equaling the aggregate average amount the insurer expects to recover in tort damages. US would replace the governing common law and statutory bars against insurers taking a subrogation or assignment interest beyond the amount that would reimburse them for payments made or promised the inured. In particular, US would allow subrogation of personal injury claims in full, including the potential recovery of non-pecuniary, punitive, and other damages in excess of the insurance benefits received by the insured.

Allowing insureds to transfer ownership of potential tort claims to first-party insurers will directly improve insureds' welfare on three dimensions:

1. Insurance: Reducing insurance premiums not only makes risk averse individuals wealthier in their uninjured condition, but also negates the compulsory "premium" (pass-through) they pay to prospective defendants through adjusted product- and labor-prices for unwanted "tort insurance" against non-pecuniary harm.

2. Deterrence: Tort liability promotes deterrence goals, including through price effects, without need for compromising insurance goals; indeed, law enforcement will be enhanced by harnessing the litigation advantages of first-party insurers: risk-neutrality, scale economies, and the investment incentives of outright ownership of tort claims.

3. Administrative Productivity: Processing of tort claims would be streamlined—with insurers also serving as mass tort class action representatives—reducing costs not only on plaintiffs' side but also for defendants and the courts.

In the long-term, there is the promise of three broader benefits. First, first-party insurer ownership of potential tort claims could catalyze an ex ante claims-market, in which consortia of lawyers and other investors would compete against insurers to purchase and prosecute prospective tort claims. Competitive ex ante claims markets (including secondary markets for claim re-sale and aggregation) provide the most efficient and effective means of achieving the deterrence ends of tort liability and generating the highest clearing price for sellers of potential tort claims. Second, the emergent ex ante claims market would establish both incentives and framework for first-party and liability insurers (joined by potential business defendants) to effect substantive and procedural tort reforms by contract. Finally, by rendering the tort system more efficient, the ex ante claims market would set the stage for legislatures to enact discretely targeted, theoretically sound reforms.

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DEREGULATING INSURANCE SUBROGATION: TOWARDS AN EX ANTE MARKET IN TORT CLAIMS

David Rosenberg[*]

I. Overview

This essay analyzes the benefits of a tort system in which commercial and governmental first-party insurers acquire complete ownership and control over the prosecution and proceeds of their insureds' prospective tort claims.[1] Insurers would treat tortious injury like any other covered risk thus paying an insured only for pecuniary loss (e.g., medical costs, lost income, etc.) according to standard policy (or program) terms.[2] In return, insureds would receive payment in the form of reduced premiums (or taxes) or other financial benefits.[3] These payments would equal the aggregate average amount the insurer expects to recover in tort damages and be distributed among insureds in accord with the insurer's standard rules for rebating or otherwise adjusting its premium (or tax) rates. Projected tort recovery, in effect, represents a stream of revenue for the insurer that offsets its operating costs: principally, coverage exposure for insured pecuniary loss and related administrative overhead. Thus, given that tort recovery lowers operating costs

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[1] I use the term "acquire" to account for both the sale of potential tort claims to commercial insurers and the retention or transfer of the ownership of potential tort claims to government insurers. Although, the proposal under study contemplates insurers acquiring tort claims at any stage of development including compete accrual and even after litigation is underway, it principally envisions acquisition before the insured realizes or even incurs any particular tortious risk. Generally, insurers would acquire an insured's total potential risk portfolio. To the extent insurers bought tort claims from insureds, and exchanged them among themselves, the proposal would constitute an ex ante claims-market involving primary and secondary trading in "tort futures."

[2] There is virtually no commercial or governmental insurance coverage for non-pecuniary harm.

[3] Generally, insurers act on averaged estimates of their coverage, costs, and adjustments to premium prices based on net-recovery from tort. In other words, insurers operate under conditions when it and insureds are deeply uncertain about the specific fate of any member of the risk pool. Thus, despite the fact that each individual has a unique "risk-portfolio," the inability of insurers to reasonably differentiate among the insureds leads to averaging out premium discounts for expected tort recovery. Note that a major distinction between commercial and social insurance is the far greater use of risk-rating by the former. Social insurance accomplishes progressive redistribution in part by averaging out risks and tax charges despite the cost-effective possibility for greater scaling of coverage and price.

and actuarially fair premiums (equal to probability of net insured loss), the insurer would reduce its charge to each insured for coverage by an amount equal to the average expected value of the net proceeds from tort (after deducting litigation costs). [4]

For example, consider an insurer that sells coverage to 100 individuals based on estimates that the average risk each presents is a 10% chance of $1000 loss, aggregating to an average loss of $100,000 with a 10% probability or $10,000. Lacking cost-effective means of differentiating the various "risk-portfolios" presented by these insureds (that is, to "price-discriminate"), the risk neutral insurer would charge each an actuarially fair average premium of $100 (ignoring administrative costs), which cumulates to $10,000, precisely the amount needed for covering the aggregate insured risk.[5] But suppose that half the insured risk stems from tortious conduct and that in the event of such tortious injury, tort will fully compensate the loss regardless of payments from the insurer or other collateral sources. Here too the insurer averages out its prospects, calculating an aggregate average offset from tort recovery of $50,000 (= 50% probability of injury from tortious conduct x $1000 average loss x 100 insureds) with a 10% probability or $5000. Again, lacking the capacity to price-discriminate based on insured-specific information relating to the relative likelihood of suffering tortious as opposed to non-tortious injury, the insurer discounts the actuarially fair premium for all, by half, thereby reducing the charge to each from $100 to $50.

I conclude that allowing insureds to transfer ownership of potential tort claims to first-party insurers will directly improve insureds' welfare on three dimensions:

1. **Insurance**: Reducing insurance premiums not only makes insureds wealthier in their uninjured condition, but also negates the compulsory "premium" (pass-through) they pay to prospective defendants through adjusted product- and labor-prices for unwanted "tort insurance" against non-pecuniary harm.
2. **Deterrence:** Tort liability promotes deterrence goals, including through price effects, without need for compromising insurance goals; indeed, law enforcement will be enhanced by harnessing the litigation advantages of first-party insurers: risk-neutrality, scale economies, and the investment incentives of outright ownership of tort claims.

3. **Administrative Productivity:** Processing of tort claims would be streamlined—with insurers also serving as mass tort class action representatives—reducing costs not only on plaintiffs' side but also for defendants and the courts.

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[4] For simplicity, we assume that insurers pay insureds the average net expected value of tort recovery in the form of some combination of reduced premium (or insurance-related tax) and increased coverage.

[5] Of course, the insurer pools an enormous number of uncorrelated risks to render it risk-neutral. Insurers operate according to the law of large numbers, positing that such risk pooling reduces to infinitesimal the chance of catastrophe, for example, all risks materializing at once.

In the long-term, there is the promise of three broader benefits. First, first-party insurer ownership of potential tort claims could catalyze an ex ante claims-market, in which consortia of lawyers and other investors would compete against insurers to purchase and prosecute prospective tort claims. Competitive ex ante claims markets (including secondary markets for claim re-sale and aggregation) provide the most efficient and effective means of achieving the deterrence ends of tort liability and generating the highest clearing price for sellers of potential tort claims. Second, the emergent ex ante claims market would establish both incentives and framework for first-party and liability insurers (joined by potential business defendants) to effect substantive and procedural tort reforms by contract.[6] Finally, by rendering the tort system more efficient, the ex ante claims market would set the stage for legislatures to enact discretely targeted, theoretically sound reforms.

My focus here is on the benefits of the proposal as a unitary system for supplying optimal insurance consistent with optimal deterrence. In particular, I will briefly explain how it promotes optimal insurance and then its value as a unitary system. Preliminarily, I will locate and develop the proposal in the more concrete terms of the existing institution of insurance subrogation.

II. Subrogation

Subrogation is defined as "stepping into someone else's shoes" for the purpose of making a legal claim.[7] Insurance companies typically use subrogation (as do most other indemnificators, like bonding companies, and creditors such as banks and mortgagees.). When they pay for the medical bills or the cost of other economic needs of one of their insureds, and that person then could or does pursue a claim for tort damages, the insurance company will invoke "subrogation." That is, it will seek either to be reimbursed from the tort recovery that the insured obtains through judgment or settlement, or, if the insured chooses not to sue, the insurer will directly prosecute the claim against the tortfeasor.

The law currently limits subrogation. Essentially, for present purposes, the insurer is limited to recouping from the insured's or its tort recovery no more than the amount of insurance actually paid or owed the insured. If the insurer paid $5000 towards

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[6] Prior work on ex ante and ex post markets in tort claims mentions insurance subrogation in passing, but usually accepts (or otherwise fails to address) the limitation of subrogation rights to compensation paid by the insurers. See Peter Charles Choharis, A Comprehensive Market Strategy for Tort Reform, 12 Yale J. Regulation 435 (1995); Robert Cooter & Steven Sugarman, A Regulated Market in Unmatured Tort claims: Tort Reform by Contract, in New Directions in Liability Law 174 (W. Olsen ed. 1988); Robert Cooter, Towards a Market in Unmatured Tort Claims, 75 Va. L. Rev. 383 (1989); Shukaitis, A Market in Personal Injury Tort Claims, 16 J. Legal Stud. 320 (1987). On related analysis of claim auctions and futures markets, see Jonathan Macey & Geoffrey Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. Chi. L. Rev. 1 (1991).

[7] On insurance subrogation, see Robert E. Keeton & Alan I. Widiss, Insurance Law §3.10(a)(1) at 220 (1988).

the insured's medical bills, then $5000 out of any tort recovery is the maximum that the insurance company can be reimbursed.[8]

What I propose is to allow first-party insurers—governmental as well as commercial—to acquire their insureds' prospective tort claims outright. Insurers would reduce premiums to reflect the average expected value of the net recovery from tort (after deducting projected litigation costs).[9] Assume that an insured was injured by a tortiously designed product and incurred medical bills of $10,000. The insurer would pay that claim and then could recover full tort damages against the product manufacturer, whether the tort action eventually paid $1 or $1 million.[10] I call my proposed system "Unlimited Insurance Subrogation" (UIS) in contrast to our current system of "Limited Insurance Subrogation" (LIS).[11]

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[8] If the insurer sued and recovered more than it paid, prevailing law requires the insurer to turn over to the insured any "excess" tort recovery.

[9] On insurers reducing premiums to reflect anticipated subrogation recoveries, see Greenblatt, J., Insurance and Subrogation: When the Pie Isn't Big Enough, Who Eats Last?, 64 U.Chi.L.Rev. 1337 (1997).

[10] Tort recoveries deviate from actual accident costs, because, as we have discussed, tort does not insure injury loss as such, but only tortious injury. Thus, tort often leaves the plaintiff bearing some or all of the loss. Of course, frequently tort pays more than the loss covered by first-party insurance. The greater scope of tort recoveries includes not only non-pecuniary harm and punitive damages, but also any pecuniary loss, which the plaintiff did or could not obtain from first-party insurers either because of commercial affordability or governmental availability.

[11] Jeffery O'Connell advanced the idea of unlimited insurance subrogation in the 1970s, see e.g., O'Connell, J., Bargaining for Waivers of Third-Party Tort Claims: An Answer to Product Liability Woes for Employers and the Employees and Suppliers, *1976 Ins. L.J. 530;* O'Connell, The Interlocking Death and Rebirth of Contract and Tort, *75 Mich. L. Rev. 659 (1977)*. I first sketched my proposal in David Rosenberg, The Uncertainties of Assigned Shares Tort Compensation: What We Don't Know Can Hurt Us, 6 Risk Analysis 363 (1986), and David Rosenberg, Of End Games and Openings in Mass Tort Cases: Lessons from a Special Master, *69 B.U. L. Rev. 695, 729 30 (1989)*. For comments on my proposal and suggestions for its use in relation to the cigarette litigation, see Hanson, J., Logue, K., & Zamore, M., Smokers' Compensation: Toward a Blueprint for Federal Regulation of Cigarette Manufacturers, 22 S. Ill. U. L. J. 519 (1998); Steven Croley & Jon Hanson, Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law, 108 Harv. L. Rev. 1787 (1995).

Subrogation and other types of reimbursement claims have recently emerged as alternatives to class actions in the field of mass torts. Most notable are the state and Blue Cross/Blue Shield suits against cigarette manufacturers to recoup Medicaid and other public health and medical expenditures for indigent and low-income smokers. Pending claims by cities against gun manufacturers seeking reimbursement for myriad municipal costs incurred from the illegal use of handguns provide another example. These suits follow the pattern of similar claims by asbestos manufacturers seeking indemnification and contribution from cigarette manufacturers for their share of the harm caused by plaintiffs' exposure to both sources of risk. The most interesting subrogation case involves a State Farm's suit against Ford Motor Company to recoup past and future insurance payments (as well as insureds' deductible costs) for personal and property damage from fire allegedly caused by defective ignition switches in millions of cars and light trucks. See Joseph B. Treaster, State Farm Lawsuit Says Ford Hid Risk of Fire in Vehicles, N.Y. Times, Jan. 21, 1998, at A1.

Because some combination of first-party commercial and governmental insurance covers everyone in the United States against serious economic loss (*e.g.*, medical expenses, lost income, repair costs, etc.), UIS would encompass the entire universe of tort claims. UIS would have its greatest effect, however, on the market for personal injury claims seeking damages for non-pecuniary harm (*e.g.*, "pain and suffering," loss of consortium).[12] Why? Because insurance policies rarely cover such non-pecuniary losses. Thus, to allow insurance companies to sue tortfeasors for such losses would be a radical change from current law.[13]

III. Optimal Insurance

The starting point for analysis is the proposition that when risk averse individuals pay the cost of insurance, they rationally prefer insurance that gives them full coverage, rather than paying a higher price for insurance that gives them more than full coverage.[14] It follows from this premise that insureds rationally prefer subrogation to no subrogation. Indeed, further analysis shows they would rationally prefer more subrogation than less, and in particular would choose UIS over LIS.

A. Rational Preference for Subrogation

Why is there any insurance subrogation? A robust explanation is that insurance subrogation increases individual expected utility above the level that would result from insurance without subrogation. Subrogation enables insureds to avoid paying for more than full insurance. It achieves this result by *effectively* excluding from first-party coverage, and hence its cost, those accidents for which tort recovery is available.[15]

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[12] Damages for "pain-and-suffering," for example comprise an estimated 26 to 57% (depending on the category of injury) of total damages awarded in cases with some positive bodily injury payments and from 50 to 76% of total damages awarded in cases with some positive pain-and-suffering payments. See W. Kip Viscusi, Reforming Products Liability 102-04 (1991).

[13] The proposal will primarily affect personal injury cases. Its effect will be much less profound in property, contract and other cases mainly involving pecuniary loss. Courts rarely authorize damages for non-pecuniary harm in those cases and thus there is substantial overlap in the coverage of insurance and recovery in tort. Insurers normally pay for the entire harm in property cases (ignoring gaps left by deductibles, exclusions and co-insurance designed mostly to thwart "moral hazard"), and occasional awards of punitive damages. As such, given the prevalence of subrogation in pecuniary loss cases, the proposal under study is largely a reality in many areas and thus can claim practical experience in its favor.

[14] For theory and examples supporting this point, See General Readings, Item #11; Notes #6-Optimal Insurance, Example 1, and related discussion.

[15] See Shavell, S., Economic Analysis of Accident Law, 235-36 (1987). In addition, as Shavell points out, subrogation eliminates the "moral hazard" problem of "double indemnity." Unlimited insurance subrogation would effectively solve the conflict between deterrence and compensation created by the collateral source rule.

To illustrate, assume the situation of the average insured in the example above, who confronts a 10% chance of losing $1000, which half of the time results from tortious conduct. In this example and those that follow, I use "I-U" to denote "individual utility" and "I-xU" to denote "individual expected utility." Also, here and in the following examples, I depict the behavior of individuals who attribute diminishing marginal utility to money by equating the utility from a given amount of money with the square root of that amount. Using square roots to translate money into utility provides a graphical curve that is fairly sensitive to marginal changes in wealth and utility. Increasing wealth incrementally, for example, from 0 to $1 to $4 to $9 to $16 yields constant, but relative to the marginal monetary gain, diminishing proportionate benefit in utility of 1, 2, 3, 4.

Compare two rule regimes, no-subrogation and LIS:

No-Subrogation: Under this regime the insurer would cover the risk of losing $1000 with a 10% probability by charging the insured $100. From the insured's perspective, there is a 10% chance of suffering a $1000 loss with a 50% probability of receiving $1000 from insurance alone, and a 50% probability of receiving $2000 from insurance plus tort.[16] The insured's total expected utility from this arrangement is calculated as the sum of the expected utility for each alternative fate:

(1) no-accident with a 90% probability: insured has net wealth of $900 (after paying $100 premium) yielding individual utility of 30 (square root of $900) with a 90% probability = 27 I-xU, plus

(2) accident with a 10% probability: insured has expected utility = 3.68, calculated as 10% x 36.79 I-xU, which is the sum of individual expected utility derived from the alternative no-tort and tort payoffs:

  (a) insurance but no-tort recovery with 50% probability = 15 I-xU, calculated 50% x 30 I-U from $900 (=$900 pre-accident net-wealth - $1000 loss + $1000 insurance), plus

  (b) insurance plus tort recovery with 50% probability = 21.79 I-xU (50% x 43.59 I-U from $1900 (= $900 pre-accident net-wealth - $1000 loss + $2000 from tort and insurance)

Total I-xU = 30.68 (= 27 I-xU in no-accident state + 3.68 I-xU in accident state)

This result is shown in the following table depicting the situation of insureds receiving tort damages instead of premium discounts:

starting	base		insurance	tort		net	net

	probability	wealth	premium	loss	payment	recovery	wealth	I-xU
no accident	0.9	$1000	$100	$0	$0	$0	$900	30
tort	0.05	$1000	$100	$1000	$1000	$1000	$1900	43.59
no tort	0.05	$1000	$100	$1000	$1000	$0	$900	30
average								30.68

LIS: Under this regime the insurer undertakes to cover the 10% chance of losing $1000, but actually ends up bearing the costs of accident only half the time (that is, half the time the insurer recoups its costs from tort). Given subrogation, the insurer's effective coverage exposure is $500 (= 50% x $1000) with a 10% probability or $50, and hence it reduces its actuarially fair premium from $100 to $50. Regardless of accident fate, then, the insured's net wealth remains the same at $950 (= $1000 - $50 premium). Thus, the insured has a 90% probability of having 30.82 I-U from $950 in the no-accident state of the world and a 10% probability of having 30.82 I-U from $950 in the accident state of the world.

Total I-xU = 30.82.

In the following table, rather than receiving a tort recovery in the event of tortious loss, everybody receives an insurance premium discount instead:

	probability	start wealth	base premium	loss	insurance payment	premium discount	net wealth	net I-xU
no accident	0.9	$1000	$100	$0	$0	$50	$950	30.82
tort	0.05	$1000	$100	$1000	$1000	$50	$950	30.82
no tort	0.05	$1000	$100	$1000	$1000	$50	$950	30.82
average								30.82

B. Rational Preference for UIS

UIS works a marked departure from the prevailing system in personal injury cases, because first-party insurance rarely if ever covers non-pecuniary harm whereas tort normally does.[17] The reason why there is no practical demand for non-pecuniary harm coverage is generally that utility from money does not provide a substitute for the loss of utility an individual derives from non-pecuniary goods. Utility from money cannot replace the sentimental value of a family photograph, loving feeling for and from a child, exhilaration of being physically fit, and obviously the joy of life when these non-pecuniary goods are lost. Moreover, attempting to offset such loss with utility from money would be prohibitively expensive.[18] UIS applies the revenue from non-pecuniary

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[17] In addition, tort pays punitive damages, which insurance doesn't.

[18] For example, assume that an individual confronts a 10% chance of suffering $1000 in medical costs from loss of a finger (which does not affect income earning capacity or otherwise adversely affect other economic interests). Also assume the individual derived 50 I-U from the finger. Now consider the individual's total expected utility given the choice between two alternative insurance policies: coverage for

damage recoveries to the insurer's entire coverage exposure for pecuniary loss, *effectively* reducing its scope and hence the costs for insureds.

Thus, to test the relative benefits of UIS compared to LIS, we pose a case of personal injury in which tort would award both pecuniary and non-pecuniary damages. For example, consider an individual with insurance covering a 10% chance of personal injury resulting in economic loss of $1000 for medical costs. Suppose that 25% of the risk emanates from tortious conduct, and in the event of tortious injury, that tort will award full damages: $1000 for economic loss plus $1000 for non-pecuniary harm. Now, compare the insured's total expected utility under two regimes, LIS and UIS:

LIS: Under this regime the insurer does not recoup from tort more than it pays out for pecuniary loss, so it will cover the 10% chance of $1000 pecuniary loss by charging the insured an actuarially fair premium of $75. (Given the 25% chance of recouping insurance costs of $1000, the insurers effective coverage exposure is 75% x $1000 with a 10% probability or $75.) Consequently, the insured's total expected utility is equal to the sum of the expected utility for each alternative fate:

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pecuniary loss of $1000 for a premium of $100; or coverage for pecuniary loss of $1000 plus non-pecuniary harm, e.g., paying $2000 (it could be any amount), for a premium of $200.

Pecuniary coverage: Under this policy the insured's total expected utility is the sum of expected utility in two states of the world

  (1) no-accident: insured has 30 I-U from $900 ($1000 - $100 premium) plus 50 I-U from the finger with a 90% probability = 72 I-xU, plus

  (2) accident: insured has 30 I-U from $900 ($900 net wealth before accident - $1000 loss + $1000 insurance) with a 10% probability = 3 I-xU

Total I-xU = 75

Pecuniary plus non-pecuniary coverage: Under this policy the insured's total expected utility is the sum of expected utility in two states of the world

  (1) no-accident: insured has 28.28 I-U from $800 ($1000 - $200 premium) plus 50 I-U from the finger with a 90% probability = 70.46 I-xU, plus

  (2) accident: insured has 42.43 I-U from $1800 ($800 net-wealth before accident - $1000 loss + $2000 insurance) = 4.24 I-xU

Total I-xU = 74.70.

The higher the coverage for non-pecuniary loss, the lower the total expected utility, e.g. paying a $300 premium for an insurance payout of $3000 creates a total I-xU of 74.01.

See Cooter, Towards a Market in Unmatured Tort Claims, *supra* note 8.

(1) no-accident state with a 90% probability, in which case the insured has net wealth of $925 ($1000 wealth - $75 premium) yielding 30.41 I-U with a probability of 90% = 27.37 I-xU, plus

(2) accident state with a 10% probability, yielding individual expected utility of 3.38, calculated as 10% x 33.78 I-xU (= 22.81 + 10.97), which is the sum of individual expected utility derived from the alternative no-tort and tort payoffs:

   (a) insurance but no-tort recovery with 75% probability = 22.81 I-xU, calculated as 75% x 30.41 I-U from $925(=$925 pre-accident net-wealth - $1000 loss + $1000 insurance), plus

   (b) insurance plus tort recovery with 25% probability = 10.97 I-xU (25% x 43.87 I-U from $1925 (= $925 pre-accident net-wealth - $1000 + $2000 from tort and insurance)

Total individual expected utility = 30.75 (27.37 I-xU no-accident + 3.38 I-xU accident)

The following table illustrates the same result:

	probability	starting wealth	base premium	loss	insurance payment	premium discount	tort recovery	net wealth	net I-xU
no accident	0.9	$1000	$100	$0	$0	$25	$0	$925	30.41
tort	0.025	$1000	$100	$1000	$1000	$25	$1000	$1925	43.87
no tort	0.075	$1000	$100	$1000	$1000	$25	$0	$925	30.41
average									30.75

UIS: Under this regime the insurer recovers full tort damages of $1000 pecuniary loss and $1000 non-pecuniary harm, and thus covers the insured's 10% chance of suffering pecuniary loss of $1000 by charging an actuarially fair premium of $50. Given its 25% chance of recovering $2000 in tort, the insurer's effective coverage exposure is $500 (= 75% x $1000 loss + 25% x $1000 net tort recovery ($2000 tort recovery - $1000 loss) with a 10% probability. Having no tort option, the insured's net wealth regardless of accident fate equals $950.

Total individual expected utility = 30.82 (= 100% x $950).

The following table illustrates the same result:

	probability	starting wealth	base premium	loss	insurance payment	premium discount	tort recovery	net wealth	net I-xU
no accident	0.9	$1000	$100	$0	$0	$50	$0	$950	30.82
tort	0.025	$1000	$100	$1000	$1000	$50	$0	$950	30.82
no tort	0.075	$1000	$100	$1000	$1000	$50	$0	$950	30.82
average									30.82

IV. Unitary System

Many of the advantages of UIS derive from the fact that it harmoniously integrates first-party insurance and tort liability in promoting insurance, deterrence, and other distributive goals. Generally, proposals for solving conflicts between these goals have focused almost exclusively on tort liability. For the most part, these proposals would impose various constraints. Some urge limiting tort liability to deterrence, treating damages as a fine that escheats to the state, and relying on first-party insurance for compensation.[19] Others argue that courts should regulate the rate of litigation by subsidizing or taxing tort awards according to their relative deterrence value, again leaving compensation to first-party insurers.[20] Many see no good solution short of abolishing tort altogether in favor of administrative regulation and insurance.[21] UIS represents a major breakthrough in offering a unitary solution that efficiently reconciles conflicts between insurance and deterrence objectives, while also promoting progressive distributive goals, and indeed rectifying significant distributive shortcomings of tort liability. UIS is not a cure-all, but it is likely to be more effective and comprehensive than the alternatives in improving individuals' welfare on all dimensions.

A. Deterrence

UIS promises many deterrence advantages, especially by enhancing the investment incentives in prosecuting tort claims. However, I focus here on the fact that UIS decreases the conflict between optimal insurance and deterrence goals within a unitary system. The principal source of the conflict is that tort deterrence may require higher or lower damages than tort insurance requires. Tort liability for pecuniary harm regardless of insurance and other collateral source payments, and for non-pecuniary harm, generally provide two of the most salient examples of deterrence objectives requiring higher damages than insurance objectives. In general, when tort pursues insurance goals at the expense of deterrence, the detriment is largely in terms of needless litigation cost. For example, tort often expends substantial resources to individualize pecuniary loss awards in mass production cases when deterrence objectives would be served far more cheaply by averaging out a statistically reliable sample of claims. But, there are many cases in which tort favors insurance directly at the expense of deterrence, for example joint and several liability with post-judgment proportional liability (e.g., contribution) as opposed to pre-judgment proportional liability (e.g., market share).

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[19] See Polinsky, M., Decoupling Liability: Optimal Incentives for Care and Litigation, 22 Rand Journal (1991).

[20] See Shavell, S., The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System (Course Documents: Additional Readings).

[21] See Sugarman, S., Doing Away with Personal Injury Law (1989).

In effect, UIS merges first-party insurance and tort liability, while separating deterrence from insurance to eliminate conflict. It secures optimal deterrence, because first-party insurers prosecute tort claims for full tort damages—pecuniary, non-pecuniary, punitive—regardless of insurance and other collateral source payments to the plaintiff. Firms will internalize expected liability equal to the total harm. Firms will adjust prices ex ante to reflect strict liability exposure or the costs of precautions that avoid negligence liability and the resulting "price effects" in competitive markets will exert discipline both on firms to minimize production costs and consumers to moderate demand for risky products. Market share can be used for deterrence purposes without concern about undercutting insurance goals. Moreover, because the insurer seeks only to recoup the aggregate averaged amount it discounted premiums, assessing tort damages by statistical sampling and assessing judgment equal to aggregate average tortious harm not only serves the insurer's interest most efficiently, but also generally coheres with deterrence objectives. At the same time, first party insurers provide plaintiffs (like other insureds) with optimal insurance, delivered far more speedily and less expensively than tort.[22]

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[22] There are many other salutary features to the unitary system created by UIS, though I make no claim that it solves all problems, especially recognizing (at least as a first approximation) that UIS will operate in the shadow of the incentives created by tort law and practice.

Moreover, several design problems may need to be addressed before UIS can be implemented. Concern is often expressed, for example, about possible difficulty in securing the insured's cooperation in a lawsuit. After being paid for the loss and having received premium reductions, what incentive exists for the insured to help the insurer win tort recovery? Of course, the insurer will have secured by contract an agreement to cooperate , which courts routinely enforce by damages or specific performance. But, sometimes the threat of legal sanctions may not suffice; indeed the insured might signal that the degree of cooperation depends on an additional payment. Yet, if the insurer pays more than the opportunity cost of the insured's time, for example in preparing or taking a deposition, then all insureds could demand equal or even greater payments for their cooperation, threatening to unravel the UIS arrangement.

There are, however, several reasons why the insureds' failure to cooperate will not be a significant impediment. First, the insured's role in litigation usually is limited to testimony supporting the claim of non-pecuniary harm and refuting allegations of contributory negligence and the like. Although the insured may be lackadaisical in offering this testimony, normally the bulk of the case is developed independently of the insured. Moreover, juries appear to assess non-pecuniary damages based on the physical harm suffered rather than the victim's personal account. Second, most insureds (and families of insureds) will have ongoing relationships with the insurer, because the insurer is paying for future loss on a periodic basis and continuing to supply insurance for reduced premia. Third, for first-party insurers the main consideration is backing their settlement demand, often to resolve a large number of cases en masse, with a credible threat of trial. Will the liability insurer or business defendant discount that threat by some estimated percentage of insured non-cooperation? Unlikely; the first-party insurer's threat is unimpeachable, and the other side knows it. In any given case, the first party insurer could pay an insured full tort damages to cooperate, and stilly profit from providing legal services. Realizing that the first party insurer never loses money even if it buys insured's cooperation, it will never pay to call its bluff. Nor will the liability insurer or defendant attempt to buy the insured's non-cooperation. The insured's contract with the first-party insurer would prevent enforcement of a non-cooperation agreement. Without its enforceability, no such agreement would be made, because without enforcement the insured is free to maximize profits by accepting payment for non-cooperation from the liability insurer and then cooperating for pay from the first-party insurer.

B. *Insurance*

The theory of general deterrence is predicated on competitive markets disciplining firms and consumers. Prices will reflect relative risks of competing products and substitutes, spurring firms to reduce risks and leading consumers to less risky choices and uses. The point is that full tort damages not only will be assessed, but also, at least to the extent strict liability is imposed, the cost of insuring those damages will be passed through to consumers. To compel consumers to pay for those damages, however, would undermine optimal insurance. In effect, when firms pass through their expected liability for full tort damages to consumers, they are requiring consumers to pay for more than full coverage of their pecuniary loss. As we have seen, individuals' expected utility decreases when they pay for more than full coverage. Many of the proposals that would assign deterrence to tort and compensation to first-party insurance neglect this dilemma.

UIS solves the problem. Firms' ex ante product price adjustments to reflect expected liability for full tort damages are completely and precisely off-set by insurers' ex ante insurance premium discounts to reflect expected recovery of full tort damages. In short, the consumer does not pay for more than full pecuniary loss coverage. However, firms' prices continue to reflect expected liability for full tort damages and thus retain virtually undiluted disciplinary effects.

C. *Additional Distributive Effects*

My focus here is on the potential for UIS to rectify problematic, and for the most part, regressive distributive effects from tort liability itself. In particular, UIS deterrence effects should progressively benefit low-income groups. Moreover, UIS premium discounts should correct tort's regressive preference for ex post rather than ex ante payment and the "tax effect" that results when consumers pay the same "tort premium" but receive differential "tort insurance."

1. <u>Deterrence Benefits</u>: In addition to increasing optimal insurance and reducing litigation costs, UIS will increase individuals' expected utility on many dimensions, especially by enhancing deterrence. Unequal distribution of wealth in reality not only implies a corresponding skew in risk-averseness, but also strongly correlates with higher relative exposure to tortious risk. Being more risk averse and more prone to tortious risk, less wealthy insureds in general should benefit proportionately more from UIS relative to the current tort system.

2. <u>Ex ante Payment</u>: Generally, ex ante, certain payment of a future benefit equal to the expected value of that benefit enhances the welfare of risk averse individuals.[23] UIS achieves this result by translating future tort damages into immediate financial gain equal to the net expected liability (that is, its expected value after deducting insurance and litigation cost). Moreover, when insurers discount premiums according to the

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[23] See Notes #4—Just Compensation.

aggregate average expected tort recovery, UIS promotes progressive redistribution. It makes insurance more affordable, thus enabling lower-income groups to extend their level of coverage toward the optimal level, and at the same time UIS puts more money in their pockets.

For example, assume that UIS premium reductions simply increase the insureds' wealth by an amount equal to the average expected recovery from tort. Specifically, suppose insureds A and B have wealth respectively of $20,000 and $50,000, and their insurance covers a tortious risk to each of losing $10,000 with 10% probability. Because of UIS, the insurer anticipates revenues from tort recovery and reduces their respective premiums by $1000, thereby increasing A's wealth to $21,000 and B's to $51,000. By providing this immediate financial benefit, UIS *progressively* increases A's expected utility by 2 % (from 141.42 to 144.91), and B's by 1% (from 223.61 to 225.83). Now suppose A bears a 15% tortious risk of losing $10,000 and B bears a 20% tortious risk of losing that amount. Given this risk disparity, UIS engendered premium discounts ($1500 for A; $2000 for B) *progressively* increase A's expected utility by 4% (from 141.42 to 146.63) and B's by 2% (from 223.61 to 228.03).[24]

3. <u>Regressive Tax Effect</u>: The high and often wasteful costs of tort litigation are passed through to plaintiffs on a relatively income-neutral basis. UIS improves individual welfare by reducing litigation costs overall. But, the distributive problems with the current system would not disappear if somehow only this great overhead were reduced, however sharply.

The problems would remain because defendants generally pass through their litigation costs in relatively uniform wage and price adjustments without regard to individual wealth. Like other forms of insurance, tort replaces plaintiffs' lost wealth, in particular lost income and income earning capacity. But, unlike other means of insurance, tort, through defendant price and wage adjustments, charges a premium unrelated to risk, specifically without regard for the amount of wealth at stake. For example, suppose that two consumers, A with wealth of $100 and B with wealth of $1000, purchase a brand of toothpaste that involves a 1% risk of personal injury resulting in a total loss. Unable to distinguish the relative wealth-related risks to A and B, the producer estimates the aggregate average expected liability and charges each consumer an average "tort premium" of $5.50 (in addition to other marginal production costs). The "regressive tax effect" arises because A, for whom the expected value of tort insurance is only $1, effectively pays a much higher than actuarially fair premium. That payment essentially subsidizes tort insurance for B, who reaps $10 in expected value from the coverage.

UIS would mitigate the regressive tax effect by charging premiums that reflect insureds' relative wealth. Moreover, to the extent UIS reduced premiums according to an average discount it would correct the tort system's regressive tax effect. Anticipating

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[24] The progressive distributive effects from UIS are even greater if, consistent with experience, A confronted the higher risk and B the lower one.

aggregate expected recovery against the toothpaste manufacturer, for example, the insurer would reduce premiums for A and B by $5.50 each.[25]

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[25] Because the insurer covers the additional 1% risk from toothpaste (not specifically, but as metaphor for coverage of potential residual risk from all goods and services), it increases the premium charge to A and B. Given UIS, the insurer will also apply a "rebate" ex ante to reduce their overall premiums by the average amount of expected tort recovery (net of insurance and litigation costs). The average is applied because the "rebate" is calculated and applied ex ante, before any tort risk exists or at least is reasonably discoverable by either the insured or insurer.

This "rebate" effectively counters the regressive tax of tort liability, because the insurer applies it to adjust the overall premium that typically is correlated with insureds' relative wealth (the major variable affecting projections of relative levels of insured loss). Each insured, in other words, pays the actuarially fair premium for total insurance coverage, including coverage of the "toothpaste" risk. Thus, in ex ante rebating the average expected recovery of $5.50, the insurer would lower A's overall premium by $4.50 (= $5.50 minus $1 to pay for the marginal cost of covering potential risks from "toothpaste"). In contrast, B's premium would increase to pay for the marginal coverage of the "toothpaste" risk; the marginal coverage adds $10 to the insurer's insured loss exposure for B. Hence, the insurer would withhold the rebate of $5.50 and charge an additional $4.50 to raise B's overall premium by the actuarially fair marginal rate of $10.