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Creating a Market for Tort Claims

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Spurred by apparent outrages such as a jury awarding $2.7 million to a woman who spilled McDonald's coffee on herself, the 104th Congress was poised to solve America's ballyhooed tort "crisis." But whatever Congress's intentions, the proposals it considered would do little to address the most serious problems of the tort system. Even worse, because of their rejection of free-market principles, these "reforms" will actually harm many businesses, while trampling the rights of tort victims.

Thanks to the gridlock of special interests, federal tort legislation seems dead for this season. Next year, instead of recycling the same old ideas and fighting the same old battles, Republicans and Democrats should look to the market for solutions. A market in which tort claims may be bought and sold to those most able to bear the risks and costs of litigation will benefit both tort victims and defendants, and will reduce the cost of the tort system generally. Just as important, instead of imposing federal standards on everyone, a tort claims market will still allow states to experiment, while enhancing the freedom of tort victims and defendants to seek solutions.

How Not to Do Tort Reform

The bills passed by the House of Representatives, H.R. 956 and H.R. 988, contain a number of questionable proposals; an example from each will illustrate just how misguided are the current attempts at tort "reform."

H.R. 956 seeks to cap noneconomic damages, such as pain and suffering, at $250,000 for medical malpractice or medical product liability. This limit applies no matter how outrageous the conduct, how dangerous the product, or how great the suffering. Who will this harm? Obviously, it will harm tort victims, but it will also harm safer doctors and hospitals, as well as sellers and manufacturers of safer medical products.

It is not fear of lawsuits that motivates most doctors, hospitals, and manufacturers to provide sound patient care and safe products. In fact, a 1994 Office of Technology Assessment report estimated that less than 8 percent of diagnostic procedures are attributable to "defensive medicine," that is, doctors acting to guard themselves against potential legal liability. Rather, the vast majority of doctors, hospital administrators, and company officers believe in behaving responsibly. Safety can cost more, but a rational tort system ensures that responsible hospitals and businesses are not at a disadvantage by imposing on their reckless or incompetent counterparts the full costs of the injuries they cause, including pain, suffering, and emotional distress.

Denying the savings that would otherwise accrue from providing safer health care or selling safer products, as this proposal would do, has the effect of subsidizing dangerous manufacturers, doctors, and hospitals. Normally, such manufacturers, doctors, and hospitals would have higher insurance or out-of-pocket costs from having to pay more in tort damages. But if liability is limited, the tort-related costs of providing unreasonably dangerous products or services will be lower. That has the effect of making such product or service providers more competitive vis-a-vis their safer competitors. Since the cap on noneconomic damages would limit the costs normally faced by negligent businesses, it is the economic equivalent of subsidizing them. That, in turn, is the equivalent of taxing safer businesses.

Even more damning, the evidence suggests that such damage caps do not work. States that have adopted similar caps have not enjoyed any savings in lower health-care costs.

H.R. 988 contains the so-called modified loser-pays rule that would shift legal costs in many cases. Under the rule, either party in a lawsuit will have to pay the other side's legal costs accrued since the time of the last settlement offer before trial, if that party could have gotten a better deal by settling. Losing defendants would have to pay if the size of the award is larger than what plaintiffs offered to settle for. Losing plaintiffs would always pay if the defendant offered them anything to settle, and even winning plaintiffs would have to pay if they could have gotten more by settling.

The rule is intended to foster settlements and thereby unclog crowded court dockets. But in fact, the vast majority of cases are already settled out of court. That occurs when the conditions for striking a deal are ripe: parties with sufficient information come to a rational determination that it is in their interest to avoid a trial.

A better way to enhance settlement prospects would be to foster the conditions necessary for settlement, such as developing information cheaply and quickly. But the House bill does not. Instead, it simply raises the risk, and therefore the cost, of going to trial. For example, if a defendant offers to settle for $5,000 and the plaintiff refuses the offer but later wins only $4,000 at trial, the plaintiff will have to pay the defendant's legal costs even though the plaintiff won. This proposal is designed to intimidate plaintiffs into settling, instead of running the risk of paying a corporation's high-priced lawyers.

But what about defendant businesses that are also subject to the rule and honestly believe that they have a good defense? Unlike most individual plaintiffs, large manufacturers and other businesses are regularly subjected to a host of lawsuits. H.R. 998 would pressure a business to settle even if it believes the claims against it are weak. Because if it does not settle, the business risks paying the legal bills not just for one plaintiff, but possibly for many others as well—a cost that could be huge. Although small and start-up businesses may not be subject to as many lawsuits, their limited capital reserves make such risks even more dangerous for them.

The bill allows a court to void the payment of legal costs if it finds that such a payment would be “manifestly unjust.” But who is likely to benefit from this safeguard, a poor plaintiff who lacked sophistication in valuing a settlement offer or some wealthy business whose army of lawyers miscalculated?

Finally, no matter what the House of Representatives might believe, settlement is not always good for corporate America. If a company shows that it is willing to settle even weak claims, plaintiffs' lawyers will demand higher settlements from that company in the future. Even worse, the company may invite a flood of similar lawsuits. Sometimes the only way to prevent a deluge of litigation is to fight. The House bill makes fighting more risky, and thus more expensive. Increasing the cost of doing business is a tort reform America can do without.

What's at Stake

Aside from these and other problems with how the bills will actually operate if they become law, their greatest failure is how little they try to achieve. Despite apoplectic talk over America's litigation explosion, recent studies, such as those by Eisenberg and Henderson published in the *UCLA Law Review*, show that for a number of years now, the number of product liability cases filed has declined; the frequency with which plaintiffs win has declined; and the average size of awards received by plaintiffs has declined. In addition, high insurance rates and unavailability of coverage have become less serious problems, although there is no consensus on why.

However, grave problems do persist, including delay in compensation; wide variance in recoveries for similar injuries (which often drives up the settlement value of a claim, despite the decline in the average award won at trial); and the huge transactions costs of the tort system, including large attorneys' fees. Mass tort litigation, involving large numbers of plaintiffs, often with varied claims and diverse interests, introduces a new set of difficulties. Standard problems of delay and inadequacy of recovery are compounded when tortfeasors (those accused of committing the tort) go bankrupt. And yet another set of problems is introduced when trust funds—established to pay successful tort claimants, including future victims, from the assets of a bankrupt tortfeasor—themselves go bankrupt. The bills passed by the House of Representatives and considered by the Senate would do nothing to address these issues.

Instead of ignoring market principles, to fix these problems Congress should unleash market forces by helping to get rid of antiquated state laws preventing the sale and purchase of tort claims. Many states continue to ban three types of actions: barratry, maintenance, and champerty.

The great English jurist Blackstone defined barratry as “frequently exciting and stirring up suits and quarrels.” For example, a lawyer cannot chase an ambulance containing an accident victim to the hospital and hand the victim a business card as they wheel him into the emergency room.

Maintenance is “an officious intermeddling in a suit that no way belongs to one, by maintaining or assisting either party with money or otherwise, to prosecute or defend it.” The ban on maintenance seeks to bar individuals from bankrolling another individual's lawsuit. But some might say that this is much like what happens when someone donates money to an activist group that sues in the public interest.

Champerty is a form of maintenance in which a stranger and a party to a lawsuit agree that the stranger will pursue the claim in consideration of receiving part of any judgment proceeds. In short, barratry refers to stirring up a lawsuit, maintenance involves supporting it, and champerty means doing so with the hope of profiting. Presumably barred by all three prohibitions, a market in tort claims is most precisely champertous.

These laws—often inherited directly from old English statutes dating back to the time of Edward I—prevent investors from investing in lawsuits or purchasing them outright. Based on medieval concepts that tort actions are personal and therefore inalienable, the laws were also an effort to stop powerful lords from manipulating medieval courts.

Fortunately, legal concepts and the judicial system have both progressed significantly since Edward I's reign. Under subrogation agreements, insurance companies pay tort victims before the case is litigated and then try recovering those payments by litigating the claims as if the companies owned them. In this context, a contingency fee is nothing more than a plaintiff's lawyer purchasing a share of a tort victim's claim in exchange for a share of the award. Similarly, state and federal rules of civil procedure, along with professional codes of responsibility, make it easier for modern-day courts to maintain their integrity and resist manipulation by the nobility and peasantry alike. There is simply no rational reason to permit ancient laws to quash an otherwise viable market, a market that would help tort victims, tort defendants, the courts, and society at large.

Advantages of a Tort Market

Currently, most tort victims must hire a contingency-fee lawyer—who typically takes a third of all that the victim recovers—and then must often wait years for a judgment. A tort claims market would enable victims, who may be out of work and facing big medical bills, to get paid by buyers immediately. Victims would also get more money because tort investors would be able to bring lawsuits more cheaply than contingency-fee lawyers, resulting in savings that could be passed on to the victim. Because tort victims would receive payments based upon average jury awards, a market would also eliminate the wide discrepancy in compensation for similar injuries.

Of course, participating in a tort claims market would be optional; victims would retain the right to proceed as they would under the current system. A tort claims market would simply expand the options available to victims by allowing them to adjust the level of risk they wish to bear; the amount and timing of the recovery they seek; and other variables to a far greater degree than they are presently able to do.

Defendants would also benefit. Currently, defendants have two choices. They can fight a lawsuit, but must bear the uncertainty of liability and damages; or they can settle, and not only give up the chance to win but also risk encouraging similar suits. In a tort claims market, defendants would be able to purchase—in other words, settle—select claims. And if they purchased those claims anonymously, defendants would be able to settle claims without encouraging new suits. Furthermore, they could invest in the very plaintiff-investors suing them. This way, a defendant would be able to offset some of the damages he must pay if the plaintiff-investor wins. Defendants could thus moderate their exposure to damages while still contesting lawsuits.

Because investors would have a lower cost of capital and would probably outbid plaintiffs' attorneys for claims, a market would foster meritorious lawsuits while discouraging less worthy claims. Deprived of cases with high expected returns, plaintiffs' attorneys would not be able to afford to bring more speculative cases. The plaintiffs' bar would no longer have an oligopsony on bringing tort claims, that is, a limited number of buyers would not have an undue influence on the compensation received by victims. This would mean that plaintiffs' attorneys would have to lower their fees in an effort to compete with claims purchasers, thereby allowing victims to receive more money—whether they sell their claims or not.

A market would also encourage plaintiffs and defendants to reach fairer, faster, and more efficient settlements. Like all capital markets, a tort claims market would develop information—about damages, liability, defendant solvency, and other complex issues—more quickly and inexpensively than the current discovery process. And tort claims buyers would have greater resources and bargaining power than the tort victims or their lawyers. Plaintiff-claims investors and defendants—both of whom would be better informed and more equally matched than under the current tort regime—would quickly be able to fashion a settlement reflecting their best interests—rather than their worst fears, as under the House's modified loser-pays scheme.

Furthermore, a tort claims market would function as a kind of insurance—*after* accidents have occurred. By letting tort victims sell their claims to others, such a market would spread the costs of accidents and the risks of recovery onto those most able and willing to bear them. And because this cost-spreading can occur after an accident, a tort claims market would address some of the problems posed by underinsurance and noninsurance.

Another defect of the current tort system is that it prohibits the free exchange of certain kinds of assets, in other words, tort claims. A tort-claims market would efficiently assign the risks and rewards of these assets to those most eager to hold them.

Who Would Sell Tort Claims, Who Would Buy Them, and Why

Currently, tort victims must hire an attorney on an hourly or contingency-fee basis in order to bring a lawsuit. Often, they must wait a considerable time to recover damages and, of course, recovery is never certain. In a claims market, tort victims would be able to sell their claims to purchasers in exchange for immediate and riskless compensation.

And in most cases, tort claims purchasers would be able to offer potentially greater compensation to victims, for three reasons. First, such purchasers will have a lower cost of capital than plaintiffs' attorneys. Plaintiffs' attorneys have a limited ability to diversify risk due to the limited size of plaintiffs' firms and to state laws that prohibit nonlawyers from investing in such firms, thereby sharply limiting their access to capital. Second, numerous laws and professional codes permit plaintiffs' attorneys to act as oligopsonists and thus not offer victims competitive compensation. Tort claims purchasers in a developed claims market would compete with each other as well as plaintiffs' attorneys to offer victims compensation. And third, tort claims purchasers would be more effective claims settlers, passing on part of the savings to the tort victim.

Although tort claims buyers would be able to offer victims numerous incentives to sell their claims, in return buyers must be assured of future cooperation from tort victims, even after they have sold their claims. For without a victim's future cooperation in discovery, testimony, and other phases of litigation, a purchaser would be unable to bring the claim, which would thereby be rendered valueless. To ensure such cooperation, claims purchasers could offer victims periodic payments instead of one lump sum; a continued financial stake in their tort claims; bonuses based upon future success; and other incentives.

Purchasing a Tort Claim

Just how much a buyer would pay for a claim depends on a variety of conditions. In the simplest scenario, a claim for $10,000 in damages might fetch a price of $9,000—the difference reflecting the cost of litigation, the time value of money, and the risk that the claim may not succeed. If the defendant is potentially insolvent, the purchase price would be further reduced to reflect credit risk.

In addition to the sale and purchase of the tort claims of individuals, it would be possible to sell shares in a single large lawsuit—usually those involving commercial disputes. The original plaintiff, usually a corporation, could retain an interest in the lawsuit and control of the litigation; or the majority shareholders of the claim could take control of the litigation.

To reduce the transactions costs associated with the sale and purchase of different kinds of claims, agents—possibly plaintiffs' attorneys—would be able to package and market claims to buyers. Such packaging might include uniform claim forms, deposition summaries, medical reports, and other information presented in a standardized, readily accessible format. Alternatively, tort buyers may do the gathering and standardizing of information themselves, thereby capturing the part of the value of a claim comprised of the information developed about it. Standardized packaging of tort claims would provide purchasers reliable information subject to efficient evaluation. Marketing such information to a variety of buyers would ensure that tort victims receive the highest payment on the most favorable terms possible.

A tort claims market would foster the development of inexpensive and accurate information in other ways. Because they have greater financial resources than plaintiffs' firms, tort investors would have greater access to technical experts; would be able to develop more sophisticated databases; and would enjoy other litigation advantages over plaintiffs' firms. For multi-victim torts, a well-developed market would enable investors to collect a diverse but representative number of claims quickly. In this way, they would be able to assess the value of individual claims—and possibly the aggregate claims—relatively quickly and accurately. Indeed, fast and efficient information processing is one of the hallmarks of capital markets. A secondary market for tort claims would further this process.

Furthermore, tort claims buyers would want to invest in a variety of claims and lawsuits in order to diversify their claims portfolios, reduce their risk, and lower their cost of capital. In the mass tort context, certain mass torts would yield very similar claims in terms of causes of action, proof of liability, and other features. Such mass tort claims resemble an aggregate of simple, individual tort claims, and tort claims purchasers would treat them similarly. Other mass torts are complex, varying in the value of the claims, applicable legal theories, and other features. Tort purchasers would buy a mix of such diverse claims arising from a common mass tort, and would invest in additional mass torts as well.

On a procedural level, a tort claims market would eliminate many difficulties currently associated with class actions for mass torts. Such a market would avoid the inter-class rivalries among various groups of plaintiffs that commonly plague mass tort litigation. Because tort investors would likely own a variety of claims from each subclass of mass tort claims, their interests would align with each other. As a result, they could join in hiring lawyers to bring cases, thereby eliminating the plaintiffs' attorneys' rivalries that currently beset many complex mass torts as well.

Furthermore, since they are more sophisticated purchasers of legal representation than are tort victims, tort claims buyers would eliminate some of the agency costs associated with contingency-fee lawyers, such as settling cases when the lawyers', rather than their clients', interests demand.

Tort investors would require significant amounts of capital in order to diversify their portfolio of claims, as well as to develop the institutional expertise to evaluate and prosecute a wide variety of tort claims. Although tort investors would be able to organize themselves in a variety of ways, a likely vehicle would be investment firms, publicly or privately held, whose assets consist of different kinds of tort claims in a diversity of lawsuits.

Whatever their structure, tort investors would have greater access to the capital markets than do plaintiffs' firms. With a larger portfolio of claims, they would have more assets on which to borrow, probably at cheaper rates. And tort claims buyers would be able to access equity markets, which plaintiffs' firms are prohibited from doing.

A Secondary Market for Trading Tort Claims

In order to bring liquidity to their investments and thus further lower their risk and cost of capital, investors would want to be able to exchange tort claims in a secondary market. The method of exchange would vary according to the value of the claim and the level of information costs associated with the exchange.

To the extent that low-value claims could be standardized, they would be exchanged in bulk in a clearinghouse fashion, much as automobile claims are settled in no-fault regimes. Low-value claims not readily subject to information standardization would not likely be purchased in the first place, but instead would be handled by plaintiffs' lawyers in a traditional manner. High- value claims would be traded on their own, since the cost of developing information about such claims is justified by the size of the damages sought. Moreover, claims of varying values and types might be bundled and securitized, in effect creating a kind of mutual fund comprised of claims. And as already discussed, very large single claims, such as commercial claims, could be securitized them