

Chapter IX

MALPRACTICE REFORM: TEN PRINCIPLES OF A RATIONAL TORT SYSTEM¹

The malpractice system is supposed to compensate victims of negligent medical practice for their injuries and discourage future errors by medical providers. It does both jobs poorly. Consider that:

- Less than 2 percent of patients (or the families of patients) who are negligently injured ever file a malpractice lawsuit; and even fewer receive any compensation.²
- Moreover, of the lawsuits filed, fully one out of every three cases does not involve any medical error.³

Further, the legal system does a bad job of sorting out good claims from bad ones:⁴

- Among those who pursue legal remedies, almost one in every six victims of malpractice receives no compensation, whereas one in every 10 meritless lawsuits results in a compensation award.

- Furthermore, malpractice victims receive less than half of every dollar (46 cents) recovered through settlements or jury verdicts; the rest pays for administration, claimant's attorney fees and defense costs.

Even as the current system fails to do a good job of ferreting out malpractice and compensating victims, it imposes large costs on doctors. Consider that one in every four physicians is sued every year, and more than half are sued at least once during their career.⁵ To protect against such lawsuits, doctors purchase malpractice insurance. Yet the premiums can be staggering — for example, more than \$200,000 a year for OBGYNs in Dade County (Miami) — and reflect the likelihood of being sued much more than the likelihood of committing actual acts of malpractice.⁶ As a result, many physicians now avoid specialties where the risk of being sued is high, especially obstetrics.⁷

Most of these costs are passed on to patients, whether or not they are victims of a medical error. The total cost of the medical tort system is estimated between \$129 billion and \$207 billion a year — or as much as \$2,000 per year for every household in America.⁸

Is there a better way of dealing with these problems? Those who have lived their entire lives under the American system of jurisprudence rarely have occasion to contemplate how things could be different. However, radically different systems can be found in other countries and civilizations. In ancient Rome, for example, there was no criminal law system, only civil law. If one Roman wrongfully killed another, the victim's family could seek redress under Roman civil law.⁹ At the opposite extreme, some European countries have no civil law system, at least as we know it, for torts. In these countries, tort claims are handled in a manner similar to criminal cases — with judges making decisions about what is to be done, without drawn-out trials and arguing attorneys. [See the sidebar on no-fault malpractice in Sweden.]

None of these systems is ideal. Take a wrongful death, for example. The primary harm that has been done is the harm to the deceased. Since any

No-Fault Malpractice in Sweden

In the 1970s, the Swedish government determined that the tort system was an inefficient mechanism for compensating victims of medical injury. The owners and funders of the nation's health care system (the Federation of County Councils) worked out a "no-fault" agreement to provide compensation to injured patients, regardless of who is at fault.¹

Compared to the tort system, the Swedish no-fault system is quick. Once a claim is made, the average resolution time is only six months. Furthermore, 82 percent of payments in Sweden go directly to the patient compared to just half of awards to plaintiffs made in the U.S. tort system. Claims are managed by adjustors in a central office in Stockholm. They determine the patient's eligibility for compensation and forward valid claims to a board of physicians who manage the compensation fund and determine payments. Compensation is awarded through periodic payments or annuities.²

Using data on 15,000 medical records from Utah and Colorado in 1992, Harvard Public Health researchers applied the Swedish criteria for a compensable injury to determine if a no-fault system would reduce costs compared to the current U.S. tort system. They found:³

- In Utah, a Swedish no-fault system would cost about the same as the state's tort system (\$55 million to \$60 million) but would compensate roughly six times as many patients — 1,465 compared to 210 to 240 under tort.
- In Colorado, no-fault would cost more than the tort system, \$110 million versus \$82 million, but would compensate more patients (973 compared to 270 to 300).

In other words, the Swedish model is more efficient, based on the cost per compensated individual. However, compensation costs are rising in countries with no-fault systems, and those countries are responding by limiting the conditions under which injuries can be compensated.

¹ David M. Studdert et al., "Can the United States Afford a 'No-Fault' System of Compensation for Medical Injury?" *Law and Contemporary Problems*, Vol. 60, No. 2, Spring 1997, pages 1-34.

² The Swedish model determines compensation based on the occurrence of an "avoidable" injury, which is determined by the answers to these questions: Did medical management cause the adverse event? Was treatment appropriate or acceptable according to a medical standard? Was the injury avoidable?

³ David M. Studdert et al., "Can the United States Afford a 'No-Fault' System of Compensation for Medical Injury?"

Source: Pamela Villarreal and Joe Barnett, "Medical Malpractice Reform," National Center for Policy Analysis, forthcoming.

harm suffered by surviving relatives is manifestly different from the harm suffered by the deceased, a spouse or family member suing for damages is an inherently imperfect way to redress the damage done.

The clearest case of this imperfection is that of a wrongful death of a child. Ordinarily, in tort cases juries are asked to assess the economic harm to the survivors. But parents don't suffer economic harm when they lose a child. If anything, they realize an economic gain (child rearing and other expenses they will no longer incur).

We believe there is no good solution to this problem in the court system. So wherever possible, people should have the opportunity to avoid the courts and turn to the marketplace — resolving disagreements by contract. The following proposals would remove some obviously perverse incentives in the current system. A reformed system will not be perfect, but it will be superior to the current system. The next chapter shows how people could have contract alternatives to litigation.

Principle No. 1: Victims of torts should be fully compensated — no more, and no less.

The goal of rational tort law should be to make the victim whole. In the case of a wrongful death, the goal should be to make the surviving family members whole. Clearly, this goal is not achieved if victims are under-compensated. Failure to fully compensate implies that the perpetrators are paying less than the full cost of the injury they cause others. That, in turn, implies that people will commit more torts than they otherwise would.

The reason for the converse principle (that victims of torts should not be overcompensated) may be less obvious. In general, we do not want people to gain from being victims. If they are able to “profit” from their victimhood, they will exercise less care and fail to take optimal precautions to avoid being victims. To the degree that loved ones influence each other's behavior, the same principle applies to compensation in wrongful death

cases. If people financially benefit from the death, say, of a family member, they will be less disposed to act in ways that prevent such deaths.

There are two immediate implications of Principle No. 1. First, assuming that an award to the plaintiff (victim) represents full and just compensation, the award should be reduced by the amount of any collateral source income, net of the cost of that income. Such income might consist of life insurance (in the case of wrongful death), disability insurance (for wrongful disability) or health insurance (for wrongful injury). Failure to reduce the award by such collateral source income would result in overcompensation to the victim.

Note that people who purchase life insurance have reduced their consumption of other goods and services in order to pay the premiums. People who fail to insure and do not pay such premiums enjoy a higher level of consumption. A rational tort system does not punish people who take the precaution of insuring or reward people who fail to insure.

Hence “net collateral income” is the proper measure of the amount that should be deducted from an award. Before reducing the plaintiff’s award by his collateral income, the premiums the plaintiff or his employer paid in order to generate that income should be returned. Put differently, the plaintiff’s award should be reduced by any collateral source income net of the premiums paid to produce that income.

The second implication of Principle No. 1 is that in cases where punitive damages are justified, the plaintiff (victim) should not be the recipient of such awards. The reason, again, is to avoid overcompensation.¹⁰

Principle No. 2: Tort-feasors should pay the full cost of their harmful acts — no more, no less.

The idea that tort-feasors should pay the full cost of their wrongful acts is likely to be widely accepted. What may be less obvious is why they should not pay more. By way of analogy, consider fines for traffic viola-

tions, such as speeding, failure to stop at traffic lights and so forth. Think of these fines as prices people pay for committing misdemeanors, and note that people may often have good reasons (at least in their own minds) for committing the violations. A husband rushing his pregnant wife to the hospital for an emergency delivery is one example. A businessman rushing to meet a deadline in order to consummate an important transaction is another. By extension, the same line of reasoning applies to the commission of torts (including, for example, torts committed by the husband or businessman in the act of committing traffic violations). A world of zero torts is not socially optimal.

From the first two principles it follows that in a rational tort system, tort-feasors (defendants) will often pay a penalty greater than what is awarded to the plaintiff. This surplus penalty consists of full compensation for damages minus net collateral source income plus punitive damages. What should happen to this surplus penalty?

A possible way to dispose of such funds is to give them to the government or use them to defray the cost of the judiciary. This remedy is not without risks, however. In general, it is probably unwise for judges to realize financial gain from their decisions, even if the gain is indirect. Similarly, the legislature which writes rules governing tort law should not get more revenue to spend as a result of their decisions.

For these reasons, a better disposition is to give the funds to worthwhile charities. The electorate could even vote on the charities that receive the funds. (However, jurors should never be told what the exact disposition of funds will be at the time they decide on the award — lest they be swayed by considerations which should have no bearing on their decision.)

Principle No. 3: Whenever possible, damages should be determined in the marketplace.

One of the most difficult issues in malpractice cases is determining actual damages. This is especially true where an injury is likely to lead to a

lifetime of continued medical care. In the typical case, the litigating parties call on expert witnesses who make educated guesses, at best. Fortunately, there is a better way. Insurance companies could bid for the right to provide continuing care indefinitely. Their bids would consist of the dollar amount they would have to receive in order to assume responsibility for the care.

Wrongful death cases are another example. A widow loses the income her husband would have earned (minus his probable consumption) plus loss of companionship. In calculating her economic loss the court must choose an appropriate discount rate, if a lump-sum award is to be made. Since courts have no special expertise in making these decisions, why not turn to those who do? For example, the defendant could be ordered to purchase an annuity to provide the widow with a continuing income.

Principle No. 4: Structured awards are generally preferable to lump-sum awards.

Under the current system, awards often require a lump-sum payment. But this only makes sense if it is a market-determined amount (for example, a bid from an insurance company). Otherwise, a better solution is a structured award — allowing for payment of damages over time. Since the loss that is being adjudicated is one that occurs over time, compensation for the loss should occur over the same period of time.

Structured settlements would allow issues to be determined in the marketplace that would otherwise be subject to arbitrary decision-making. They may also be a more efficient way of handling other issues that are fraught with uncertainty.

Consider the lifetime of continuing medical care. A jury does not know whether or not a new drug will make continuing care unnecessary five years from now. It should not have to guess. With a structured award, the financial burdens for the defendant could be reduced, say, to the cost of the

new drug if and when it is developed. Such adjustments are not possible with lump-sum, up-front awards.

With respect to the surviving spouse, it is impossible to know whether or not she will find new companionship (and a new income stream) five years from the time of the verdict, and a jury should not have to guess. A structured award can be adjusted at a future date in light of such changes in circumstances.

Principle No. 5: Parties should always be free to alter by contract a court-determined award.

Although structured awards of the type described above constitute good public policy, there are innumerable reasons why the parties in a specific case may prefer a different arrangement. If so, they should be allowed (and even encouraged) to voluntarily make mutually beneficial adjustments. In this way, the court sets the parameters, but the particulars of the compensation are determined by contract. (A structured award, for example, could be replaced by a lump-sum payment if both parties are willing.)

Principle No. 6: Reasonable limits should be set on damages for pain and suffering, subject to market-based rebuttable evidence.

The difficulty with assessing damages for pain and suffering is that the injuries are experienced subjectively. Since there is no objective test, a case can be made for limiting their size.¹¹

At first glance, Principle No. 6 may seem to completely contradict the spirit behind Principle No. 3 — determining damages in the marketplace. In fact the two principles can complement each other. Take the case of wrongful deaths. Many states place a limit of about \$250,000 on non-economic damages (pain and suffering) for a surviving spouse. Obviously people differ in what they subjectively experience. But there is a way that

markets may again be used to reveal these differences. Suppose a husband has a \$1 million life insurance policy on his own life and his wife is the beneficiary. After his wrongful death, economists calculate that the economic loss to the wife is \$600,000. In this case, a reasonable inference is that the couple places an additional value of \$400,000 on the noneconomic loss — as evidenced by the payment of life insurance premiums. The couple has revealed through their actions that \$400,000 rather than \$250,000 is the appropriate value for noneconomic damages.

Principle No. 7: Punitive damages are justified only if there are social costs over and above the victim's private costs.

Why should there ever be punitive damages? Phrases such as “send them a message” or “teach them a lesson” have no real place in a rational tort system and should not be allowed as arguments before a jury. For the reasons given above, under ordinary circumstances the defendant should pay full damages and only full damages.

The case for punitive damages rests solely on the proof that there are social costs in addition to the private costs. Suppose a doctor has committed malpractice, and the course of discovery reveals the existence of other probable victims who never learned of the malpractice that led to their injuries. In this case, awarding full damages to the plaintiff is not enough penalty. The reason: The total probable harm done by the doctor is much greater than the harm done to the defendant. In assessing punitive damages, jurors should be encouraged to consider social harm, and only social harm.

Principle No. 8: Contingency fees should be paid entirely by the defendants, with meritorious exceptions.

If Principle No. 1 is followed, the plaintiff's award will be reduced by net collateral source income, and no punitive damages will be received by

the plaintiff. So if there is a contingency fee arrangement under which the plaintiff's attorney receives, say, one-third of the judgment, the fee must be based on the amount the plaintiff actually receives. Furthermore, if there is a structured award — requiring the defendant to make periodic payments over time — the plaintiff attorney's fee will also have to be paid over time. But are these rules really fair?

Consider a plaintiff with no collateral source income. The attorney gets one-third of the full award under a typical contingency fee agreement. Now suppose there is \$100,000 of net collateral source income. The plaintiff's award will be reduced by that amount because the collateral source income replaces part of the defendant's damage payment. The attorney and client in this case could agree that the attorney will receive one-third of the collateral source income, to be paid by the plaintiff, as well as one-third of the reduced award.

Now consider punitive damages. These are imposed because there are social costs over and above the damages at issue in the lawsuit. Just as it would be overcompensation for patients to receive punitive damages, it would also be overcompensation for the plaintiff's attorney to receive one-third of them.

The general principle is: Lawyers should be paid the way their clients (plaintiffs) are paid. This principle should also apply to class action lawsuits, which sometimes involve millions of consumers with small individual losses. Awards should not be allowed that give cash to lawyers and “dollar-off” coupons to their clients. If the clients are paid in coupons, the lawyers should be paid in coupons as well. An exception should be made for especially meritorious suits. These are cases, for example, where an attorney invests considerable time and expense to uncover wrongdoing that would otherwise go undetected. The principle here should be: The lawyer's share of the private award is determined by contract (the contract between lawyer and client), while the lawyer's share of the social award (punitive damages) is determined by the court.

Principle No. 9: Attorney's fees should be awarded in cases of bad faith.

There is far more bad faith in the judicial system than there are attorney fee awards. That's unfortunate. There would be much less bad faith if the penalties for engaging in it were higher.

Bad faith on the plaintiff's side often consists of filing frivolous lawsuits. Bad faith on the defendant's side often consists of intentional delays — forcing plaintiffs to spend time, money and effort to collect on claims when fault is not really in question.

To enforce Principle No. 9, judges should be more aggressive. Where bad faith is strongly suspected, the attorney-client privilege should be suspended as well as work product shields and other traditional privileges in order to ferret it out.

Principle No. 10: The first nine principles do not apply to settlements.

If the first nine principles are desirable rules to govern tort cases before the court, why shouldn't judges insist they also apply to any settlement? The practical reason is that the administration of justice is costly. In the very act of going to court, both the plaintiff and the defendant are imposing costs on everyone else as taxpayers. For this reason, there is a social interest in encouraging settlements.

If the first nine principles are followed at trial, there would be a substantial sum of money given to charity in many cases. Principle No. 10 says that the sum of money does not have to be given to charitable institutions if there is an agreed-upon settlement. Thus, the first nine principles create a powerful economic incentive for the two parties to reach a middle ground and avoid a trial. Even if they misjudge their prospects by a wide margin, both parties may still view a compromise as financially attractive.

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An exception to this principle is the class action suit, and the reason for the exception is that in a class action lawsuit plaintiffs do not really have full standing. Typically, they do not appear in court and have not entered into a formal contract with the lawyer who represents them.

CHAPTER XI — TEN PRINCIPLES OF A RATIONAL TORT SYSTEM

Notes

- 1 The authors are indebted to Richard Epstein, Paul Rubin and Thomas Saving for helpful comments on this section.
- 2 A. Russell Localio et al., “Relation between Malpractice Claims and Adverse Events Due to Negligence. Results of the Harvard Medical Practice Study III,” *New England Journal of Medicine*, Vol. 325, No. 4, July 25, 1991, pages 245-251.
- 3 David M. Studdert et al., “Claims, Errors and Compensation Payments in Medical Malpractice Litigation,” *New England Journal of Medicine*, Vol. 354, No. 19, May 2006, pages 2,024-33.
- 4 Ibid.
- 5 Angela M. Dodge and Steven F. Fitzer, “When Good Doctors Get Sued,” Dodge Publications, 2001; cited in “How Often Doctors Get Sued for Medical Malpractice: Medical Malpractice.” Available at http://www.wrongdiagnosis.com/medical-malpractice/how_often_doctors_get_sued_for_medical_malpractice.htm.
- 6 Government Accountability Office, “Medical Malpractice Insurance: Multiple Factors Have Contributed to Increased Premium Rates,” GAO-03-702, June 2003. Available at <http://www.gao.gov/new.items/d03702.pdf>.
- 7 Robert Quinn, “Medical Malpractice Insurance: The Reputation Effect and Defensive Medicine,” *Journal of Risk and Insurance*, Vol. 65, No. 3, September 1998, pages 467-84.
- 8 Calculations are based on estimated costs of defensive medicine from Daniel Kessler and Mark McClellan, “How Liability Law Affects Medical Productivity,” *Journal of Health Economics*, Vol. 21, No. 6, November 2002, pages 491-522; health care expenditures are from “National Health Expenditures by Type of Service and Source of Funds: Calendar Years 2005-1960,” Centers for Medicare and Medicaid Services; and estimated tort costs are from Towers Perrin Tillinghast, “2006 Update on U.S. Tort Cost Trends.”
- 9 See, for example, Henry Sumner Maine, *Ancient Law: Its Connection With the Early History of Society, and Its Relation to Modern Ideas* (London: John Murray, 1861).
- 10 In several states (Alaska, Indiana, Iowa, Missouri, Oregon, Utah, Florida, Georgia and Illinois), punitive damages paid to the plaintiff are shared with the state. For example, Oregon requires 60 percent of punitive damages paid go into the state’s victims’ compensation fund. See “Litigation Statistics,” available at <http://www.footnotetv.com>; and McCullough, Campbell and Lane, LLP, “Summary of United States Medical Malpractice Law.” Available at <http://www.mcandl.com/publications.html>.
- 11 For an argument that no noneconomic damages should be awarded, see Paul V. Niemeyer, “Awards for Pain and Suffering: The Irrational Centerpiece of Our Tort System,” *Virginia Law Review*, Vol. 90, No. 5, September 2004, pages 1,401-21. Rubin argues that while there exists a insurance market for health, disability and life insurance, no market exists for “pain and suffering” or other noneconomic damages. The reason: individuals are unwilling to buy this type of coverage because the costs outweighs the benefits. He concludes that people have revealed through their actions that they place a low value on pain and suffering compensation. See Paul H. Rubin, *Tort Reform by Contract* (Washington, D.C.: American Enterprise Institute, 1996).