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Liability Rights As Contingent Claims

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Abstract

A contingent claim is a right to receive money or goods in the event that a possible event actually occurs. A liability right is a right to money damages contingent upon conditions stipulated in law, such as the injurer's negligence causing the victim's harm. When the contingencies occur, a liability right matures into a legal right of action with a claim to damages. In principle, the victim could transfer his right to receive damages to someone else, and the injurer could pay someone else to assume his obligation to pay damages. The transfers could occur before or after the liability right matures. Exchange in a complete set of perfectly competitive markets allocates liability rights efficiently, regardless of the initial allocation by law. In practice, the law impedes such exchanges. Legal reforms could facilitate the development of competitive markets for liability rights, rather than impeding exchange. I explain briefly how competitive exchange could solve the problems of deterrence and insurance, lower the transaction cost of dispute resolution, and improve the quality of consent to waivers of liability.

Liability Rights As Contingent Claims

A contingent claim is a right to receive money or goods in the event that a possible event actually occurs. Different people place different values on the risks represented by contingent claims. These differences create potential gains from trade that an efficient market exhausts. Beginning in the 1950's, general equilibrium theorists produced increasingly robust proofs that a complete set of competitive markets for contingent claims allocates risks efficiently (Arrow and Hahn 1971). General equilibrium theorists apparently had in mind such contingent claims as stock options, insurance, commodity futures. Their arguments, however, also apply in principle to legal liability for some kinds of harm.

A liability right is conventionally defined as a right of the victim to receive money compensation from the injurer in the event that possible harm actually occurs (Calabresi and Melamed 1972). A liability right thus combines the victim's right and the injurer's liability. A liability right is contingent upon conditions stipulated in law, such as the injurer's negligence causing the victim's harm (Cooter 1991). When the contingencies occur, a liability right matures into a legal right of action with a claim to damages.

In principle, the victim could transfer his right to receive damages to someone else, and the injurer could pay someone else to assume his obligation to pay damages. The transfers could occur before or after the liability right matures. To illustrate transfer of an unmatured liability right, a person who

purchases medical insurance typically assigns to the insurer any legal rights to compensation for medical costs arising from accidents (“subrogation clause”). Similarly, a company that purchases liability insurance pays the insurer to assume liability. To illustrate transfer of matured liability rights, an accident victim who sues the injurer in the US typically retains an attorney on a contingent fee, which assigns approximately 1/3 of any court judgment to the plaintiff’s attorney.

Different people place different values on the risks that trigger liability, and these different valuations create potential gains from trade. To realize these gains, a potential victim should sell the right to receive damages to someone who values it more, and a potential injurer should pay someone else to bear liability who can do so at less cost. If perfectly competitive markets for liability rights existed, they would reach equilibrium when every right to receive damages is owned by the party who values it the most, and every duty to pay damages is held by the party who can bear it at least cost. Such an equilibrium is Pareto efficient with respect to the allocation of matured and unmatured liability rights.

Law often impedes or forbids the exchange of liability rights, especially liability arising from accidents. For example, consumers and manufacturers cannot usually contract to modify the rights of consumers to receive compensation for injuries caused by defective products. Courts disallow so many contracts to waive, disclaim, modify, or transfer liability for accidental harm that the mainstream in tort scholarship proclaims the decline or death of contracts for liability rights (Atiyah 1979) (Calabresi 1976) (Gilmore 1974). Lawyers or

law firms in the US and elsewhere apparently cannot buy unmatured liability rights (prohibition of “champerty”). Contingent fees allow lawyers in the US to buy a fraction, but not all, of a matured liability claim. Continental Europe typically prohibits contingent fees.

Inefficiencies in liability law impose high costs on society (Huber 1988; Viscusi 1996). Would removing the legal impediments to markets for liability rights solve these problems? No one can accurately predict how markets would develop. Presumably some markets would flourish and others would fail. Some legal theorists favor allowing disclaimers and waivers, or developing new contracts to exchange liability rights (Havighurst 1986; Priest 1981; Rubin 1997) **(Cooter 1989) (Choharis 1995)**, and other scholars are more circumspect or hostile to contract remedies in torts **(Geistfeld 1994) (O'Connell and Joost 1986) (Bell 1990; Croley and Hanson 1993; Sugarman 1992)**.

I believe that many of the historical abuses of contracts for liability rights resulted from the absence of competition. Competitive exchange holds promise as a remedy for inefficient tort laws. Instead of impeding exchange, law should facilitate competition in markets for liability rights. I will examine the main causes of potential gains from trade, describe the legal impediments, and speculate on how markets might emerge if the legal impediments were removed.

Deterrence versus Insurance

Potential victims of accidents desire deterrence and insurance. I will explain how this desire creates a strong incentive to exchange liability rights. In simple tort models, optimal deterrence requires injurers to internalize the external

benefit of avoiding accidents. In these simple models, injurers internalize the external benefits of precaution when they are liable for perfectly compensatory damages (Brown 1973). Damages are perfectly compensatory when they restore the victim to the same level of utility as he would have enjoyed without the injury. In other words, the victim is indifferent between no injury or an injury with perfectly compensatory damages.

Courts distinguish between economic and non-economic losses caused by accidents. The economic losses include property damage, lost wages, and medical costs. The non-economic losses include pain, suffering, emotional distress, and lost companionship. Optimal deterrence requires perfect compensation, and perfect compensation requires damages for economic and non-economic losses. To illustrate concretely, assume an accident causes losses of 20 for hospitalization, 50 for lost wages, and 30 for pain and suffering. Perfect compensation requires damages equal to 100. Assume the injurer can take precautions that reduce the probability of an accident. When the injurer decides how much precaution to take, liability of 100 causes the injurer to internalize the full gain that more precaution conveys upon the potential victim. Consequently, the injurer balances his own costs of precaution against its benefit to the victim.

The right to receive perfectly compensatory damages fully insures potential victims against the destruction of value in accidents where the injurer is liable. Full insurance, however, may not be optimal. People buy insurance in order to shift money from a state of the world in which money is needed less to a

state of the world in which money is needed more. In other words, people buy insurance against accidents that increase the marginal utility of money. In the typical case, economic losses cause the marginal utility of money to rise, so people will buy insurance against economic losses. In the typical case, however, non-economic losses do not cause the marginal utility of money to rise, so people will not buy insurance against non-economic losses (Cook and Graham 1977). (Rare examples of people buying insurance against pain are found in (Croley and Hanson 1995).)

Law that pursues the ideal of perfect compensation or the goal of optimal deterrence awards damages for economic and non-economic losses, thus over-insuring. Law that pursues the goal of optimal insurance does not award damages for non-economic losses, thus under-detering. To illustrate, a tort system similar to the US, which provides large awards for pain and suffering, will set liability approximately at 100 in the preceding example and optimally deter the injurer. The victim, however, probably has no desire to insure against pain and suffering. A tort system similar to Germany's, which provides little compensation for pain and suffering, will set liability closer to 70, thus under-detering the injurer and supplying the efficient amount of insurance to the victim.

Combining optimal deterrence and optimal insurance requires the potential injurer to pay relatively high damages and the potential victim to receive relatively low damages. In private law, the injurer's obligation to pay damages usually *equals* the victim's right to receive damages. This equality creates a tradeoff between the two goals, and different legal systems respond differently to

this trade-off. To achieve both goals, law must decouple payments to the injurer and victim. Specifically, law can require the injurer to pay a relatively high fine to the state and relatively low damages to the victim (Polinsky and Che 1991).

Instead of decoupling by law, which has disadvantages, decoupling can occur through markets. When the liability system provides the potential accident victim with unwanted insurance, a market for liability rights permits him to sell it. If the buyer is anyone other than the potential injurer, the sale reduces insurance without reducing deterrence. To illustrate, a potential victim with liability rights equal to 100, who wants insurance equal to 70, can sell the right to recover damages equal to 30. The buyer might be a law firm specializing in accidents. After completing the sale, the victim of an injury recovers 70 in damages as required for optimal insurance, and the injurer pays a total of 100 -- 70 to the victim and 30 to the law firm -- as required for optimal deterrence. Thus sales of unmatured tort claims by potential victims to third parties eliminates unwanted insurance without reducing the injurer's incentives for precaution.

1st Party or 3rd Party Insurance?

I explained that liability law provides unwanted insurance and creates an incentive to sell liability rights. The preceding discussion assumed that insurance is unwanted because the harm does not increase the marginal utility of money. Another reason why the victim may not want the injurer to provide insurance is that the victim can buy it cheaper.

To illustrate, consider a manufacturer who sells a product to a retailer, who resells the product to a consumer. If the manufacturer is strictly liability for

consumer product injuries, then the manufacturer in effect sells a joint product consisting in a manufactured good and an insurance policy. In contrast, a rule of no liability exposes the consumer to the risk of injury, thus providing an incentive for the consumer to purchase his own insurance. No-liability induces 1st party insurance, and strict liability induces 3rd party insurance. If 3rd party insurance is cheaper than 1st party insurance, then a rule of strict liability is more efficient than a rule of no liability in simple tort models. Conversely, if 1st party insurance is cheaper than 3rd party insurance, then a rule of no liability is more efficient than a rule of strict liability in simple tort models.

Priest argues that the legal doctrine of enterprise liability replaced relatively cheap 1st party insurance with relatively expensive 3rd party insurance (Priest 1985; Priest 1991). If Priest is right, lawmakers created the wrong rule that imposes excessive insurance costs upon consumers. A market for liability rights can correct this mistake. By assumption, the consumer can insure at less cost than the manufacturer, so an exchange of liability rights creates a surplus. The manufacturer can profitably buy the consumer's liability right at a price exceeding the consumer's cost of insurance. A consumer who sells a liability right and buys insurance converts 3rd party insurance into 1st party insurance.

Transaction Costs

Schwartz found that the plaintiffs' legal costs in the typical American tort suit equal between 29% and 44% of the damages awarded (Schwartz 1985). Assuming defendant's legal costs are similar in magnitude, total legal costs exceed 60% of the damages awarded. Reducing the costs of resolving disputes

motivates many proposals for tort reform, including proposals to replace fault-based liability with no-fault rules (O'Connell and Joost 1986).

Instead of restricting sales to third parties, suppose the potential victim can sell a liability right to the potential injurer. The potential injurer who buys an unmatured liability right extinguishes the potential plaintiff's claim before an accident occurs. In the event of an accident, no one will incur the high cost of litigation and the victim will bear his own accident costs. Thus the sale of liability rights can effectively convert liability from fault to no-fault without actually changing the law. Saving the transaction costs of dispute resolution provides a motive for victims to sell liability rights to injurers.

What is the effect on deterrence? In simple tort models, a reduction in liability reduces the injurer's incentives for precaution. To illustrate by the preceding example, an injurer who buys the victim's right to receive damages of 30 reduces his liability from 100 to 70. After the transaction, the injurer internalizes only 70% of the benefit of avoiding an accident, so the injurer may reduce his precaution and the number of accidents may increase.

Competition, however, tends to prevent this erosion of incentives. The market price of liability rights responds to the frequency and magnitude of damages. To be more precise, the price of an unmatured liability right in competitive equilibrium roughly equals the expected judgment in the event of an accident, discounted by the probability of an accident (Cooter 1989). By reducing precaution and increasing the number of accidents, an injurer causes

the price of liability rights to rise. The rise in price reduces the profitability of the injurer's strategy of buying liability rights in order to reduce precaution.

To illustrate, assume that an injurer planned to purchase liability rights from potential victims and then reduce his precaution. Competitors who understand the injurer's strategy will buy liability rights in anticipation of a rise in their price. The rise in the price of liability rights increases the cost to the injurer of pursuing his strategy. As an alternative strategy, the injurer could commit to taking efficient precaution, thus reducing the market price that the injurer must pay to buy liability rights from victims.

The transaction costs of markets for liability rights are large. Successful markets must aggregate unmatured rights and sell them in bulk. Insurers could play an important role as a broker in bulk sales. For example, automobile insurers could offer lower premiums to drivers in exchange for their liability rights arising from automobile accidents, including the right to damages for pain and suffering. In the event of an accident involving two drivers with such insurance, the drivers would make claims against their insurance companies and the insurance companies would resolve liability with each other. Insurance companies might contract to pre-settle such claims, thus eliminating court proceedings.

As another example, assume that you buy a used Volvo and the manufacturer is liable for accidental harm caused by a manufacturing defect. You might get a reduction in your auto insurance premium in exchange for transferring to the insurer your liability right against Volvo. Your insurer would

then resell such liability rights in bulk to Volvo, thus extinguishing any possible suit. If Volvo gets too careless, a law firm specializing in liability rights might outbid Volvo and purchase a block of liability rights from the insurer.

The same exchange might occur for the right to recover damages from injuries caused by medical malpractice. Specifically, the patient could transfer his right to recover damages for medical malpractice to his insurance company in exchange for lower premiums, and the insurance company could resell the right to the patient's doctors or their insurers.

Consent

The best rationale for disallowing contracts for liability rights concerns asymmetrical information. A person who does not know the quality of a product cannot value it correctly. Similarly, a person who does not know the probability and magnitude of a loss cannot value it correctly. If competition drives the price of liability rights to their value, however, ignorant individuals can transact in these markets simply by knowing the market price.

To illustrate by analogy, consider a competitive market for fire insurance. Most homeowners know little about the probability of a fire. Competition among insurers, however, tends to equate the insurance premium with the expected value of claims plus administrative costs. Consequently, every consumer can be ignorant of probabilities and magnitudes of losses, and yet all consumers who pay the competitive price for insurance receive it at cost. A competitive market for liability rights would work the same way. Instead of trying to learn about probabilities, most rational individuals would focus on learning about the prices of

liability rights. Thus an ignorant consumer, who knows nothing about the probability or magnitude of accidents, would receive full value for liability rights.

Conclusion

Regarding liability rights as contingent claims invites an extension of models of competitive exchange to liability law, which could change law in theory and practice. The extension could replace intuition in legal theory with rigor and bring a new perspective to regulating risks. Exchange in a complete set of perfectly competitive markets allocates liability rights efficiently, regardless of the initial allocation by law. Legal reforms could facilitate the development of competitive markets for liability rights, rather than impeding exchange. Competitive exchange would solve the problems of deterrence and insurance, lower the transaction cost of dispute resolution, and improve the quality of consent to waivers of liability.

Since law impedes or prohibits markets for liability rights, no one knows how they would develop or whether they could become competitive. The success of such markets would depend upon the ability of entrepreneurs to develop new contingent commodities by unbundling and repackaging liability rights. If large, unrealized surpluses from such exchanges exist, pressure will build to liberalize markets for liability rights.

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