What Liability Crisis?
An Alternative Explanation for
Recent Events in Products Liability

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Increasing premiums and the withdrawal of some kinds of coverage in
commercial liability insurance markets are widely believed to have led some
manufacturers to raise product prices and to withdraw certain products from
the market. These changes have been attributed to the expansion of manufac-
turer liability for product-caused injuries, and have been seen as evidence that
products liability law is in need of fundamental reform. This Article challenges
the theoretical and empirical foundations of that well-accepted view through
a careful examination of the work of Professor George L. Priest, one of the
most influential leaders of the tort reform movement. Croley and Hanson first
consider and reject the conventional explanation for the liability "crisis." They
then argue that any expansion toward enterprise liability furthers the deter-
rence and insurance goals of tort law by forcing consumers to internalize the
full pecuniary and nonpecuniary costs of product-caused injuries. Finally,
Croley and Hanson argue that recent changes in commercial liability insurance
and consumer product markets may well represent the desirable consequences
of efficient changes in products liability law. They urge courts and legislatures
to continue the expansion toward enterprise liability.

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We are grateful to Guido Calabresi, Jules Coleman, Henry Hansmann, Bill Malley, Susan Rose-
Ackerman, Alan Schwartz, the participans of the Yale Student Legal Theory Workshop, and especially
Kyle Logue for helpful comments. We would also like to thank the John M. Olin Foundation for funding
portions of this research. An earlier version of this article was awarded Yale Law School's John M. Olin
Prize and Yale Law School's Benjamin Scharps Prize. Very special thanks to Kathleen Hanson, Laura
Sagolla, and our parents.

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Yale Journal on Regulation Vol. 8: 1, 1990
Introduction

A. The Current Consensus in Products Liability

Developments in products liability over recent decades have been characterized as a "revolutionary" shift away from principles of contract and negligence toward the principle of enterprise liability.\(^1\) This shift can be understood as the latest stage in the evolution of products liability.\(^2\)

Originally, determinations of liability for product injuries sounded in contract. Injured consumers could recover only if they were in privity of contract with a product's seller, and recovery was limited to the terms of any express or implied warranties.\(^3\) Privity and notice requirements together posed an almost insurmountable bulwark for consumers seeking recovery in tort.\(^4\) In the second stage, courts gradually relaxed these contract requirements, turning to tort law and its principle of negligence.\(^5\) A plaintiff could recover from a manufacturer of a defective product by showing that the manufacturer's product caused the plaintiff's injury and that the manufacturer was negligent.

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1. See R. COOTER & T. ULEN, LAW AND ECONOMICS 422 (1988); R. RABIN, PERSPECTIVES ON TORT LAW 154-55 (2d ed. 1983) ("[C]ourts have effected a veritable revolution in products liability law during the last decade, substituting strict liability in tort for a liability system based on the fault principle."); Epstein, The Unintended Revolution in Product Liability Law, 10 CARDOZO L. REV. 2193 (1989) [hereinafter Epstein, Unintended Revolution] (This shift "has not been incremental but revolutionary."); Huber, Flypaper Contracts and the Genesis of Modern Tort Law, 10 CARDOZO L. REV. 2263, 2270 (1989) [hereinafter Huber, Flypaper Contracts] ("The revolution in the law of torts has been as profound and far-reaching as any in the history of the common law."); Priest, The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law, 14 J. LEGAL STUD. 461, 461 (1985) [hereinafter Priest, Enterprise Liability] ("Since 1960, our modern civil liability regime has experienced a conceptual revolution that is among the most dramatic ever witnessed in the Anglo-American legal system. Legal rules that had been entrenched for decades... were suddenly repudiated and replaced by rules... radically different."); TORT POLICY WORKING GROUP, AN UPDATE ON THE LIABILITY CRISIS 54 (1987) [hereinafter TORT POLICY WORKING GROUP, 1987 UPDATE] ("The recent expansion of tort liability doctrines has been one of the most dramatic and far-reaching developments in modern American law. The most active and visible area of expanding tort liability has been that of product liability."). See generally R. EPSTEIN, MODERN PRODUCTS LIABILITY LAW chs. 2-4 (1980); P. HUBER, LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES (1988); Epstein, Products Liability as an Insurance Market, 14 J. LEGAL STUD. 643, 645, 654-69 (1985) [hereinafter Epstein, Insurance Market]; Epstein, Unintended Revolution, supra, at 2196-2213; Landes & Posner, A Positive Economic Analysis of Products Liability, 14 J. LEGAL STUD. 535, 547-51 (1985).

2. Enterprise liability has been defined as follows: "Enterprise liability... provides in its simplest form that business enterprises ought to be responsible for losses resulting from products they introduce into commerce." Priest, Enterprise Liability, supra, at 463; see also Blum & Kalven, The Empty Cabinet of Dr. Calabrest: Auto Accidents and General Deterrence, 34 U. CHI. L. REV. 239, 245 n.14 (1967) (using the term "enterprise liability" in this way). The authors' use of the term "enterprise liability," is consistent with the above definition—that is, as a label for a products liability regime in which manufacturers are absolutely liable for the costs of product accidents, notwithstanding exculpatory contracts. In other words, "enterprise liability" denotes absolute manufacturer liability that cannot be altered by contract. See generally S. Croley & J. Hanson, Understanding Products Liability (unpublished manuscript) [hereinafter S. Croley & J. Hanson, Understanding Products Liability].

3. The authors' intent here is simply to provide a general historical backdrop necessary for understanding the current thinking in products liability. For a more complete historical picture, see R. Epstein, supra note 1; Priest, Enterprise Liability, supra note 1.


for failing to discover or eliminate the product's defect. The importance of contract remained, however, for courts continued to enforce the terms of manufacturers' express warranties. In the third stage, courts abandoned contract doctrines altogether, holding negligent manufacturers liable even when the manufacturers had disclaimed liability through express warranties. Finally, in the 1950s and 1960s, courts substituted in place of negligence a rule of strict liability.

In two classic articles, Dean Prosser explained that courts adopted strict liability because of their confidence that such a rule would best serve the two primary goals of products liability, deterrence and insurance. Courts believed that strict liability would provide an incentive for manufacturers to prevent accidents that they could efficiently prevent (the "deterrence goal") and to spread the risk of unpreventable accidents (the "insurance goal"). But as Prosser recognized, the strict liability regime was less strict—that is, more fault-based—than its name suggests. The strict liability rule did not make manufacturers absolute insurers for purchasers of their products.

6. Epstein, Unintended Revolution, supra note 1, at 2200 (arguing that this stage stood for the "rejection of freedom of contract").
7. See, e.g., Heningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960); see also Greenman v. Yuba Power Products, Inc., 59 Cal. 2d 57, 63, 377 P.2d 897, 901, 27 Cal. Rptr. 697, 701 (1963) ("the refusal to permit the manufacturer to define the scope of its own responsibility for defective products makes clear that the liability is not one governed by the law of contract warranties but by the law of strict liability in tort").
8. See Greenman, 59 Cal. 2d 57; see also RESTATEMENT (SECOND) OF TORTS § 402A (1965) (adopting strict products liability standard). This major turn of events was anticipated in, if not instigated by, Justice Traynor's 1944 concurring opinion in Escola, in which Traynor argued that "the manufacturer's negligence should no longer be singled out as the basis of a plaintiff's right to recover ...." Escola v. Coca-Cola Bottling Co., 24 Cal. 2d 453, 461, 150 P.2d 436, 440 (1944) (Traynor, J., concurring). Traynor's opinion has been called "the most prominent antecedent of our modern regime." Priest, Enterprise Liability, supra note 1, at 498; see also P. HUBER, supra note 1, at 132.

On the development of strict products liability up to that time, see James, Products Liability, 24 TENN. L. REV. 44, 192 (1955); Noel, Manufacturers of Products—The Drift Toward Strict Liability, 24 TENN. L. REV. 963 (1957).
9. Prosser, The Assault Upon the Citadel (Strict Liability to the Consumer), 69 YALE L.J. 1099 (1960) [hereinafter Prosser, The Assault]; Prosser, The Fall of the Citadel (Strict Liability to the Consumer), 50 MICH. L. REV. 791 (1966) [hereinafter Prosser, The Fall]. In these classic articles, Prosser borrows, expands, and mixes Cardozo's citadel metaphor. (Cardozo observed that "the assault upon the citadel of privity is proceeding in these days apace." Utamarres Corp. v. Touche, 255 N.Y. 170, 180, 174 N.E. 441, 445 (1931)). In general, the "citadel" is the fortress that resisted the early stages of the enterprise liability..
10. Deterrence and insurance have been widely accepted as the twin goals of products liability, indeed, of tort law in general. See Huber, Flypaper Contracts, supra note 1, at 2272; Alan Schwartz, Proposals for Products Liability Reform: A Theoretical Synthesis, 97 YALE L.J. 353, 368-69 (1988) [hereinafter Schwartz, Proposals].
11. See, e.g., Escola, 24 Cal. 2d at 462, 150 P.2d at 440 (Traynor, J., concurring); Greenman, 59 Cal. 2d at 63, 377 P.2d at 901.
13. See Prosser, The Assault, supra note 9, at 1114 ("An honest estimate might very well be that there is not one case in a hundred in which strict liability would result in recovery where negligence does not."). See generally Landes & Posner, Products Liability, supra note 1, at 553-66 (comparing modern products liability doctrines to negligence).
14. Plaintiffs still had the burden of identifying a product defect and showing that it existed when the product left the defendant's hands. And the judicial test for determining whether a product was defective, many scholars have argued, was equivalent to the test for determining whether the manufacturer was negligent. See, e.g., R. COOTE & T. ULEN, supra note 1, at 434; Calabresi & Hirschoff, Toward a Test for Strict Liability in Torts, 81 YALE L. J. 1055 (1972); Session Three: Discussion of Paper by George L. Priest, 10 CARDOZO L. REV. 2339, 2335 (1989) [hereinafter Discussion Session Three] (remarks by David Friedman); Landes & Posner, Products Liability, supra note 1, at 546, 549, 554; see also infra notes.
What Liability Crisis?

Tort scholars believe that after 1964, until at least 1985, courts, offering the same insurance and deterrence justifications that originally prompted their shift to "strict" products liability, have expanded manufacturer liability yet closer to an enterprise liability regime—a regime in which manufacturers would be absolutely liable for injuries caused by their products. Although questions remain about the exact magnitude of this latest expansion, recent scholarship reflects a consensus that the expansion, whatever its magnitude, has generated much more harm than good.

This consensus emerged largely in response to the so-called "insurance crisis," which peaked in the early months of 1986. Escalating commercial liability insurance premiums at that time caused tremendous concern among business leaders, policymakers, and insurance companies. Commenta-

17 and 88 and accompanying text (reviewing scholars' arguments that current products liability regime is largely indistinguishable from a negligence regime). Even some courts recognize the equivalence. See, e.g., Prentis v. Yale Mfg. Co., 365 N.W.2d 176, 184 (Mich. 1984) (stating explicitly that risk-utility test is nothing other than a negligence test).

Moreover, a plaintiff had to demonstrate that the product's defect caused the injury. See R. Epstein, C. Gregory & H. Kalven, Cases and Materials on Torts 638 (4th ed. 1984); Viscusi, Toward a Diminished Role for Tort Liability: Social Insurance, Government Regulation, and Contemporary Risks to Health and Safety, 6 Yale J. on Reg. 65, 69 [hereinafter Viscusi, Diminished Role]. And even then, a defendant could avoid liability by showing that the plaintiff had assumed the risk, misused the product, or been contributorily negligent.

15. See R. Cooter & T. Ulen, supra note 1, at 422 ("[P]roducts liability law... from 1965 to the present... is characterized by the emergence of strict liability as the basis for recovery for harms arising from product use, and the trend toward a standard of absolute liability for manufacturers."); Litin, Swire & Winston, The U.S. Liability System, Background and Trends, in LIABILITY: PERSPECTIVES AND POLICY 5-11 (J. Litin and C. Winston eds., 1988); Priest, Enterprise Liability, supra note 1, at 527 ("The unfolding of enterprise liability since 1964 might be viewed as a struggle of courts to define some coherent conception of manufacturers' liability short of absolute liability... But the distance between prevailing standards and a standard of absolute liability progressively narrows.").


17. See, e.g., Epstein, Unintended Revolution, supra note 1, at 2196 ("The present rules of product liability law are both inefficient and unwelcome...."); Priest, Modern Tort Law and Its Reform, 22 Val. U. L. Rev. 1 (1987) [hereinafter Priest, Modern Reform] ("Modern tort law as currently defined largely thwarts the accident reduction and compensation objectives."); Schwartz, Proposals, supra note 10, at 384 ("This regulation [i.e., the current control that courts and juries attempt to exert over product quality]... has been unfortunate.").

18. Priest, Modern Reform, supra note 17, at 2-3.

tors offered various explanations for the crisis, including the popular claim that insurers were colluding to maximize profits. But each explanation left components of the radical changes in liability insurance markets unexplained. Legal economists provided the most persuasive explanation when they linked the insurance crisis to the expansion of manufacturer liability. What was initially viewed as an insurance crisis came to be viewed as fundamentally a tort crisis or, to capture its cause, a “liability crisis.” It is now widely believed that changes in products liability caused the insurance crisis, and that the insurance crisis is evidence of a crisis in products liability.

20. See infra note 41.
21. See generally TORT POLICY WORKING GROUP, 1987 UPDATE, supra note 1, at ch. 4. In 1984, the insurance industry instituted a campaign to convince policymakers and business leaders that tort law was to blame for the drastic increases in insurance premiums. Maher, I.I.I. Launches New Ad Campaign, NAT'L UNDERWRITER (Prop. & Casualty ed.), Dec. 21, 1984, at 2, col. 1. For example, the Insurance Information Institute spent more than six million dollars to advertise the message that the insurance crisis was the consequence of a tort crisis. Comment, Rumors of Crisis: Considering the Insurance Crisis and Tort Reform in an Information Vacuum, 37 EMORY L. J. 401, 404 (1988). To understand why commercial insurance carriers have opposed expansions in products liability, see infra Part IV(D)(2).

Another theory is the “insurance cycles” hypothesis. Clarke, Warren-Boulton, Smith & Simon, Sources of the Crisis in Liability Insurance: An Economic Analysis, 5 YALE J. ON REG. 367, 384-85 (1988). Both Danzon and Abraham argue that the “insurance cycles” hypothesis cannot fully account for the increase in insurance prices and decrease in availability. P. DANZON, MEDICAL MALPRACTICE 107 (1985); Abraham, Making Sense of the Liability Crisis, 48 OHIO ST. L.J. 399, 400-01 (1987) (hereinafter Abraham, Liability Crisis). Another explanation is that state regulation was so severe that it caused a breakdown in the market for liability insurance. Clarke, Warren-Boulton, Smith & Simon, supra, at 386-89. This explanation is implausible, however, since state regulation did not change in any systematic way prior to the insurance crisis. Id. at 388-89.
24. It is tempting to call what others have deemed the “liability crisis” the “liability juncture,” because authors sometimes seem to rely on the term “crisis” to carry the normative burden of their arguments. Cf. T. MARMOR & J. MASHAW, SOCIAL SECURITY: BEYOND THE RHETORIC OF CRISIS 4 (1988) (“Our governmental institutions fragment attention in an already diverse polity, making regular incremental adjustment difficult and thoughtful reassessment nearly impossible. . . . Thus those who want action. . . . resort to cries of ‘crisis’ to prompt action.”). Because the term is now widely accepted, however, we will continue to use it. A few have resisted characterizing recent changes in tort law and insurance markets as a “crisis.” Indeed, Viscusi has written:

The so-called liability “crisis” of the 1980s is simply a reflection of the market response to the increased costs imposed by tort liability. Decisions to discontinue products that are the subject of litigation are rational responses to changing economic circumstances. Such changes are not necessarily evidence of a crisis. The analysis needed to determine whether a crisis exists, or whether an efficient redistribution of risky activities is taking place, must involve an evaluation of the tort system and of how the liability insurance market functions.

Viscusi, Diminished Role, supra note 14, at 82. The purpose of this Article is to provide just such an analysis.
What Liability Crisis?

Today, no one seems to doubt that products liability is in need of drastic reform.26 The energetic, theoretical debate over the comparative deterrence effects of different products liability standards has all but disappeared.27 The energies of tort theorists have been devoted instead to articulating the sources of the crisis and proposing specific reforms.28 Although their specific recommendations differ, scholars are now telling lawmakers that the movements toward enterprise liability have, contrary to the predictions and good intentions of the “founders,”29 thwarted the deterrence and insurance goals of modern products liability. They argue that these goals can be realized only by moving away from enterprise liability back toward principles of contract and negligence.30 These scholars are, to revive Prosser’s metaphor, urging courts to rebuild the Citadel.31

Among others, Kenneth Abraham,32 Patricia Danzon,33 Richard Epstein,34 Peter Huber,35 George Priest,36 Alan Schwartz,37 Michael

28. Indeed, the American Law Institute is reviewing and developing proposals for reform of the Restatement (Second) of Torts § 402A. See AMERICAN LAW INSTITUTE, COMPENSATION AND LIABILITY FOR PRODUCT AND PROCESS INJURIES: PROGRESS REPORT 26-27 (April 13, 1987).
29. See P. HUBER, supra note 1 (using the term “founders” to refer to the previous generation of products liability scholars, who endorsed and perhaps instigated the shift toward enterprise liability); Priest, Modern Reform, supra note 17, at 5 (same).
30. Scholars disagree about what the optimal liability rule would be, and, for any given liability rule, they disagree about the extent to which manufacturers and consumers should be permitted to contract around the liability rule. In general, however, most believe that the liability rule should be more like negligence and less absolute liability than it now is, and that contract should play a more important role than it now does. For an analysis of several scholars’ views on these issues, see S. Croley & J. Hanson, Understanding Products Liability, supra note 1.
31. See supra note 9 (explaining Prosser’s citadel metaphor).
33. See P. Danzon, A Second Look at Tort Reform (paper prepared for the Round Table on Tort Reform, sponsored by the Institute for Law and Economics, University of Pennsylvania, April 27, 1990) [hereinafter P. Danzon, A Second Look at Tort Reform]; see also Danzon, Tort Reform and the Role of Government in Private Insurance Markets, 13 J. LEGAL STUD. 517 (1984) [hereinafter Danzon, Tort Reform] (volatility of legal rules creates nondiversifiable risk which in turn substantially raises costs of liability insurance); Danzon, Comments on Landes & Posner: A Positive Economic Analysis of Products Liability, 14 J. LEGAL STUD. 569, 574 (1985) (“[t]he costs of insurance are unnecessarily high because the courts have, misguided, used the tort system as a vehicle for social insurance.”).
34. Among other things, Epstein argues that there is a “tension between the customary judicial belief that liability insurance justifies extended tort liability [and] the recent failures of insurance markets.” Epstein, Insurance Market, supra note 1, at 645.
35. Huber summarizes his view as follows:

The legal system, often as random and capricious as the accident itself, yields less insurance and—perversely—still more accidents. . . . A cure is at hand, if we can find judges willing to
Trebilcock,\(^{38}\) and Ralph Winter\(^{39}\) have, based on a set of related arguments, provided courts and legislators with blueprints for the Citadel's reconstruction.\(^{40}\) These commentators have had a powerful influence on the shape and direction of products liability,\(^{41}\) yet their views have received surprisingly little criticism.\(^{42}\)

**B. Challenging the Consensus**

In the hope of reviving the debate about the direction that products liability should take, this Article critically examines the arguments for products liability reform. It provides an alternative explanation for the empirical phenomena that appear to have convinced commentators, courts, and legislatures that there has been a liability crisis and that there is need for reform. This Article concludes that courts should complete the shift toward enterprise liability. This subject administered it . . .

Huber, *Insurance, Not Lawsuits, for the Accident Prone*, Wall St. J., Sept. 28, 1988, at 24, col. 3; see P. Huber, supra note 1, at 224-27.  
36. *See infra* note 47.  
37. *See* Schwartz, *Proposals,* supra note 10. After criticizing current doctrines and proposing reform, Schwartz concludes that "[j]udges should recognize the imprudence of driving further along what may be the wrong road." *Id.* at 415.  

41. *See, e.g.,* Henderson & Eisenberg, *The Quiet Revolution in Products Liability: An Empirical Study of Legal Change,* 37 *UCLA L. Rev.* 479 (1990) (providing evidence that courts have been quietly moving back toward more traditional products liability rules since the mid-1980s); Labaton, supra note 20, at D2 (quoting Epstein: "There is no question that at the appellate level, there has been some winding down in the last three years. Plaintiffs don’t walk over defendants anymore. It’s a different game now."); Rabin, *Indeterminate Risk,* supra note 17, at 635-36 ("the process of retrenchment has already begun"); *Courts May Have to Legalize Liability Reform,* Wall St. J., Nov. 9, 1989 (discussing impact of scholarship on increasing the chance of fundamental judicial restructuring of products liability). In addition, almost every state has passed legislation in response to the crisis. Priest, *Modern Reform,* supra note 18, at 3-5 (describing state reform statutes); Sandros & Joyce, *"Off to the Races": The 1980s Tort Crisis and the Law Reform Process,* 27 *Hous. L. Rev.* 207, 218-23 (1990) (summarizing provisions of tort reform legislation adopted in 48 jurisdictions between 1985 and 1988).

is of more than historical interest; products liability remains an "explosive" area.\(^{43}\)

The alternative explanation that this Article provides can be summarized roughly as follows. Recent events in consumer product markets—in particular, the withdrawal of some products and price increases for others—are largely the welcome result of efficient changes in products liability law. Expanded manufacturer liability has resulted in the internalization of two significant externalities. Before the expansion of liability, consumers and manufacturers did not take into full account the nonpecuniary costs of product-caused injuries. Those costs were, in effect, externalized upon the unlucky consumers who happened to suffer product-caused injuries. Similarly, prior to the expansion, consumers did not take into full account the pecuniary costs of product accidents for which they were insured. That was true because first-party insurers rarely and imperfectly adjust premiums according to a consumer's decisions about which and how many products to consume, and about how carefully to consume them. Consequently, consumers externalized part of the costs of their consumption choices upon their fellow first-party insureds. This second externality, like the first, led consumers and manufacturers to under-invest in accident prevention.

Following the expansion of manufacturer liability, injured consumers more often recovered from manufacturers for the nonpecuniary as well as the pecuniary costs of product accidents. To avoid liability, manufacturers increased their investments in safety, driving up the nominal price of their products. And to cover their liability costs for any accidents that they could not efficiently prevent, manufacturers had to raise prices. Consequently, product prices rose to reflect more closely real costs. Once price increases forced consumers to internalize the full costs of product accidents, consumption patterns changed, and the market for some products disappeared altogether.

Recent reverberations in the liability insurance market represent welcome market responses to the efficient expansions in manufacturer liability. Greater use of policy exclusions and copayment mechanisms, for instance, reflects insurers' efforts to combat moral hazard by ensuring that manufacturer-insureds make all cost-justified investments in accident prevention. The movement of insureds to alternative forms of liability insurance such as mutuals (or risk retention groups) does not reflect a "breakdown" in liability insurance


Although reforms have already occurred in most jurisdictions, see supra note 41, the reforms have been neither systematic nor comprehensive. See Rabin, Some Reflections on the Process of Tort Law, 25 SAN DIEGO L. REV. 13, 19 (1988). But systematic change may be imminent. Even Vice President Dan Quayle is calling for federal laws to limit products liability awards. See Meier, Product Dead-Ended by Liability Fears, N.Y. Times, May 19, 1990, § 1, at S0, col. 3. And recently there has been "[a] titanic struggle under way in Congress over legislation that would overhaul product-liability law." Abramson, Product-Liability Bill Provides Opportunity for Long-Term Milking of PACs by Congress, Wall St. J., June 21, 1990, at A16, col. 1.
markets. On the contrary, changes in products liability law altered the relationship between liability insurers and their insureds, such that mutuals became the most efficient form of insurance for some insureds. Simply put, these alternative forms of organization provided insureds (that is, member manufacturers) with a superior means of coping with moral hazard and socio-legal uncertainty. This alternative explanation is presented more fully in Parts III and IV below.

C. Overview

In developing its criticism of the current reform movement, this article focuses mainly on the scholarship of Professor George L. Priest. In his prominent academic career, Professor Priest has written many articles criticizing the premises upon which the shift toward enterprise liability was originally based, describing the adverse effects of that shift, and calling for judicial reform of the current regime. There is little question that Priest has provided the most comprehensive account of the liability crisis, and he is duly

44. See, e.g., Priest, Modern Reform, supra note 17, at 1 ("Today we are beginning to learn that the presuppositions upon which [modern tort law] was built are flawed, and that this transformation of the law has adversely affected the welfare of U.S. citizens."); id. at 10 ("[T]he modern implementation of the goals of accident reduction and compensation insurance is built upon two empirical presuppositions which the founders thought to be true but which, regrettably, are false, indeed dangerously false.").

45. See, e.g., id. at 5 ("[A]lthough the founders of our modern tort regime embraced the goals of accident reduction and compensation, the elaboration of modern law in recent years has lost sight of these goals, and has ignored what can and what cannot be effectively accomplished through common law rules. As a consequence, modern tort law as currently defined largely thwarts the accident reduction and compensation objectives."); id. at 5-6 ("[A]lthough modern tort law is committed to accident reduction and compensation, it does a scandalously poor job of controlling the accident rate and an even poorer job of providing compensation to the injured."); id. at 8 ("[T]he goals of the [modern] law are unexceptionable, but the methods through which the law is to be implemented are counterproductive and reduce the welfare of consumers and the welfare of poor and low-income consumers most of all."); id. at 10 ("[M]odern law . . . has disrupted liability insurance markets and has led to a reduction in the total level of accident insurance available in the society.").

46. See, e.g., Discussion Session Three, supra note 14, at 2330 (remarks by Priest) ("I hope to delegitimize the regime by showing the mundane sources of the revolution. The revolution owed its origin to ideas that ought to be reconsidered."); Priest, Insurance Crisis, supra note 19, at 1589-90 ("In my view, modern tort law provides inadequate controls on the accident rate and simultaneously creates a tort law insurance regime that disrupts insurance markets and harms the poor. The objectives of tort law reform are uncontroversial: to reduce the accident rate and to provide a more coherent and comprehensive regime of compensation insurance. [T]o achieve these objectives, modern tort law must be reformed systematically: by a complete redefinition of liability standards to better achieve accident reduction and insurance."); Priest, Modern Reform, supra note 17, at 5-6 ("If our society is seriously interested in accident reduction and compensation insurance, modern tort law must be vastly reorganized . . . .").

recognized as one of the most influential scholars in the field. Therefore, this Article takes Priest’s scholarship as its focal point. But because other scholars of the crisis movement offer arguments very similar to Priest’s and rely on many of his conclusions, what follows largely applies to them as well.

By calling into question the prevailing view of the “liability crisis,” this Article aims to unsettle the current consensus. Disarming those calling for reform is, however, a secondary goal. The primary objective of this Article is to show that where products liability law has shifted toward enterprise liability, the changes brought about by that shift have been efficient. If it is not too late for the law to move still closer to an enterprise liability regime, this Article concludes, it should move in that direction with confidence.

Part I begins by distinguishing two products liability regimes—enterprise liability and negligence. It then presents and critically assesses three components common to most explanations for the liability crisis: (1) the high administrative costs of an enterprise liability regime; (2) the inefficiencies of awarding damages for nonpecuniary losses; and (3) the inability of manufacturers and third-party insurers to combat the problem of moral hazard.

Part II focuses on the core of Priest’s theory, his characterization of insurance risk pools—what they are, how they are maintained, and why they have recently “unraveled.” Part II scrutinizes Priest’s argument concerning the negative effects of adverse selection in the context of insurance risk pools and his claim that the crisis is primarily the result of such unravelling.

Parts III and IV offer an alternative explanation for the insurance crisis. Part III argues that recent events were not a “crisis” but rather a welcome consequence of efficiency-enhancing changes in the law. Part IV then evaluates the competing explanations—Priest’s “unravelling theory” and the alternative

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48. Priest is commonly named as the most, or one of the most, important participants in this literature. See S. SUGARMAN, supra note 39, at 80-82 (1982); Ayres & Siegelman, The Economics of the Insurance Antitrust Suits: Toward an Exclusionary Theory, 63 TUL. L. REV. 971, 972 (1989); Schwartz, Proposals, supra note 10, at 354 n.2; Sanders & Joyce, supra note 41, at 223-26.
“internalizing theory” presented in Part III—by comparing their respective abilities to explain the empirical phenomena associated with the “crisis.”

I. First-Party Insurance versus Manufacturer-Provided Insurance

A. Introduction to Part I: Distinguishing Regimes

Most legal economists agree that an efficient products liability regime would accomplish two economic goals. First, it would encourage parties to prevent all accidents that can be efficiently prevented (the “deterrence” goal). Second, it would efficiently allocate the risk of unprevented accident costs (the “insurance” goal).49

In Priest’s view, the trend away from negligence toward enterprise liability has not helped to deter injuries caused by manufacturers’ products.50 Theoretically at least, deterrence would be optimal under either a negligence or an enterprise liability regime, because manufacturers have sufficient incentives under either regime to prevent all accidents that they can efficiently prevent.51 Priest believes that the only difference between the two regimes is which party bears the burden of insuring against accidents that manufacturers cannot efficiently prevent: under negligence, consumers bear the burden of insuring against such accidents, and they respond by purchasing first-party insurance, whereas, under enterprise liability, manufacturers provide insurance with their products which consumers pay for as part of a product’s price. Thus, the choice between liability rules amounts to little more than a choice between insurance mechanisms.

The question becomes crucial, then, whether first-party or manufacturer-provided insurance is more efficient. According to Priest, those who promoted the expansion of manufacturer liability wrongly presumed that manufacturer-provided insurance is more efficient.52 Courts believed that “risk spreading can best be provided by manufacturers, rather than by consumers in private insurance markets, because manufacturers can easily collect a small insurance

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49. Legal economists commonly emphasize the distinction between the deterrence and insurance components of a liability rule. See, e.g., P. DANZON, supra note 22, at 3; Calfee & Winston, Economic Aspects of Liability Rules and Liability Insurance, in LIABILITY: PERSPECTIVES AND POLICY, supra note 26; Danzon, Tort Reform, supra note 33, at 518 (1984); Graham & Pierce, Contingent Damages for Products Liability, 13 J. LEGAL STUD. 441, 441 (1984); Priest, Insurance Crisis, supra note 19, at 1537.

50. Indeed, Priest has suggested that the trend may have caused an increase in the number of accidents. Priest, Warranty, supra note 47, at 1350-51. This is not to say, however, that Priest considers the old regime to be the most efficient of all possible regimes. See infra note 88.

51. Priest, however, does not consider research and development issues sometimes emphasized by proponents of enterprise liability. Priest, Modern Reform, supra note 17, at 9-10. See generally Calabresi & Hirschoff, Toward a Test for Strict Liability in Torts, 81 YALE L.J. 1055, 1063 (1972) (discussing effects of liability rules on research and development); R. COOTER & T. ULEN, supra note 1, at 367 (same).

52. See Priest, Understanding the Crisis, supra note 47, at 204 (“The extension of liability to achieve insurance ends . . . is the most likely explanation for the tremendous growth in tort litigation.”).
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premium in the price charged for the product.\textsuperscript{53} Because manufacturers were believed to have provided inadequate insurance coverage in their warranties, courts decided that the law should require them to provide adequate coverage.

Priest argues, however, that recent “crisis” phenomena belie courts’ earlier assumptions about the efficiency of manufacturer-provided insurance. According to Priest, manufacturer-provided insurance is, for several reasons, less efficient than first-party insurance.\textsuperscript{54} First, by forcing manufacturers to compensate consumers for injuries that manufacturers cannot efficiently prevent, the current regime forces manufacturers to provide consumers with insurance\textsuperscript{55} that consumers do not demand.\textsuperscript{56} Consumers neither need nor want manufacturer-provided insurance because they have their own health and disability insurance\textsuperscript{57} and are thus covered if they suffer a product-related injury.

Furthermore, Priest argues that the shift from first-party to manufacturer-provided insurance actually impaired insurance markets.\textsuperscript{58} Although courts and legal scholars assumed that manufacturers could either self-insure or buy commercial liability insurance and then simply add the cost of legal exposure to the price of their products and services, Priest argues that such an assumption reflected a naive over-simplification of the relationship between tort law

\textsuperscript{53} Priest, \textit{Enterprise Liability}, supra note 1, at 520; see also Priest, \textit{Modern Reform}, supra note 17, at 7, 14-15.


\textsuperscript{55} Priest writes: “If the [court] determines that neither party could have prevented the loss in a cost-effective manner, then the resolution of the dispute in favor of the plaintiff or the defendant serves only to determine which party is to be the insurer for the loss . . . .” Priest, \textit{Insurance Crisis}, supra note 19, at 1537.

\textsuperscript{56} \textit{Discussion Session Three}, supra note 14, at 2338 (remarks by Priest).

\textsuperscript{57} For the sake of argument, this Article accepts Priest’s assumption that consumers have first-party insurance against the risks of product-related injuries. Priest claims that only a tiny fraction of the American population is without some form of basic health and disability insurance, and that fraction—consisting of “occasional workers, transients, and the homeless”—is not central to the policy issues at stake. Priest, \textit{Insurance Crisis}, supra note 19, at 1552, 1586-87; see also Priest, \textit{Modern Reform}, supra note 17, at 5, 18-20; Priest, \textit{Liability Crisis}, supra note 47, at 4-5; Priest, \textit{Understanding the Crisis}, supra note 47, at 204-07; Priest, \textit{Compensation}, supra note 25, at 133-38; Priest, \textit{Liability Costs}, supra note 47, at 323-24. Tort scholars generally seem to accept the proposition that consumers are, for the most part, insured against the pecuniary costs of product injuries. See, e.g., P. Danzon, supra note 22, at 14; W. Landes & R. Posner, \textit{The Economic Structure of Tort Law} (1987); Viscusi, \textit{Product Liability and Regulation}, supra note 54, at 303 (rationale for strict liability is anachronistic, inasmuch as it “was developed before the advent of Medicare and Medicaid, the increase in workers’ compensation benefit levels, and the extensive health and life insurance coverage of the American work force.”). However, first-party insurance may be much less widespread than these scholars assume. See Gold, \textit{The Struggle to Make Do Without Health Insurance}, N. Y. Times, July 30, 1989, at 1 (37 million persons in America lack medical insurance, and 88% of the uninsured are working people and their families); Moyer, \textit{A Revised Look at the Number of Uninsured Americans}, Health Affairs, Summer 1989, at 102, 104-05 (31.1 to 36.8 million persons uninsured in America); Waldman, \textit{The Insurance Mess}, Newsweek, Apr. 23, 1990, at 46.

\textsuperscript{58} Priest, \textit{Insurance Crisis}, supra note 19, at 1550-61; Priest, \textit{Liability Crisis}, supra note 47, at 5-6; Priest, \textit{Liability Costs}, supra note 47, at 323.
and third-party insurance markets.\textsuperscript{59} The "extension of tort law," Priest argues, has "led to a withdrawal of commercial insurance capacity."\textsuperscript{60} Priest believes that third-party insurance provided through the tort system differs systematically from first-party insurance in ways that work to undermine insurance markets: [1] third-party insurance is much more costly to administer; [2] it provides far more and different coverage than consumers would choose to buy voluntarily; and [3] perhaps most important, it disrupts efforts to distinguish high-risk from low-risk customers, a distinction that makes the business of insurance possible.\textsuperscript{61}

For these three reasons, Priest urges courts to adopt his proposed cost-benefit negligence standard.\textsuperscript{62} These purported differences between first-party and manufacturer-provided insurance are examined in turn.

B. \textit{Three Purported Shortcomings of Manufacturer-Provided Insurance}

1. \textit{Administrative Costs}

Critics of the current regime commonly argue that manufacturer-provided insurance is much more costly to administer than first-party insurance is. Professor Priest writes:

The administrative costs of insurance delivered through tort law are vastly greater than the administrative costs of any first-party insurance regime. Blue Cross-Blue Shield first-party health insurance administrative costs are 10% of benefits; SSI disability insurance administrative costs are 8% of benefits; Workers' Compensation disability insurance administrative costs are (a much-criticized) 21% of benefits. In con-

\textsuperscript{59} Priest explains:

The failure of the insurance enterprise is tragic because it appears to be an artifact of the form of insurance delivery. . . . It appears . . . to be the consequence of a misguided attempt of judges to increase insurance capacity by enlisting the tort system as an additional insurance source. The expansion of tort system insurance, however, has not significantly broadened insurance coverage; it has undermined it.

Priest, \textit{Liability Crisis}, supra note 47, at 7; see also Priest, \textit{Modern Reform}, supra note 17, at 14-15.

\textsuperscript{60} Priest, \textit{Understanding the Crisis}, supra note 47, at 204.

\textsuperscript{61} Id. at 207; see also Priest, \textit{Accident Rate}, supra note 47, at 185-86 (making similar claim); Priest, \textit{Insurance Crisis}, supra note 19, at 1526 (same); Priest, \textit{Modern Reform}, supra note 17, at 10 (same); Priest, \textit{Liability Costs}, supra note 47, at 333 (same).

\textsuperscript{62} "It is these basic differences between first- and third-party compensation insurance coverage that account for the recent insurance availability crisis in the United States." Priest, \textit{Compensation}, supra note 25, at 140; see also Priest, \textit{Liability Costs}, supra note 47, at 323 (same). Sugarman too has called for a substitution of first-party insurance in place of manufacturer-provided insurance. See Sugarman, \textit{Taking Advantage of the Torts Crisis}, 48 Ohio St. L. J. 329 (1987).
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... tort law administrative costs are estimated to be 53% of net plaintiff benefits.\(^{63}\)

Although these statistics show that administering tort law is currently costly, indeed more costly than administering first-party insurance,\(^{64}\) they do not support the conclusion that a negligence regime is less costly to administer than an enterprise liability regime.

As noted above, Priest believes that negligence and enterprise liability each provide optimal deterrence because each encourages parties to prevent all preventable accidents (that is, all accidents that can be prevented cost-justifiably). Accordingly, when comparing the administrative costs of the insurance provided under the two regimes, he focuses on the costs of administering claims for unpreventable accidents that occur under either regime. In comparing administrative costs, in other words, Priest is concerned with only the following question: Which regime between enterprise liability \textit{qua} insurance and first-party insurance administers unpreventable accident claims less expensively?

Before examining Priest's answer to this question, it is important to point out that he construes the term "preventable" narrowly, to include only those accidents that can be cost-justifiably prevented through investments in care ("care-unpreventable" accidents).\(^{65}\) This definition is not standard. Legal economists typically apply the label "preventable" to accidents that can be prevented through cost-justifiable reductions in activity levels as well as to accidents that can be prevented through cost-justifiable investments in care.\(^{66}\)

At any rate, Priest's administrative-cost analysis can be criticized on several grounds. One stems from the well-accepted argument that, as a

\[^{63}\] Priest, \textit{Insurance Crisis}, supra note 19, at 1560 (citing J. KAKALIK \& N. PACE, \textit{COSTS AND COMPENSATION PAID IN TORT LITIGATION} (1986)); see also Priest, \textit{Compensation}, supra note 25, at 140; Priest, \textit{Liability Costs}, supra note 47, at 323 (third-party insurance is "perhaps five to ten times as costly" as first-party insurance; "[d]espite the belief that third-party tort-law insurance is more efficient than first-party coverage, . . . experience has shown its administrative costs to be much more substantial—by a magnitude estimated a 2.75 to 5.75 times."); Rabin, \textit{Indeterminate Risk}, supra note 16, at 639 (administrative costs of tort system are "enormous"); Trebilcock, \textit{Insurance Considerations}, supra note 23, at 259 (same); Viscusi, \textit{Product Liability and Regulation}, supra note 54, at 304 (same); Viscusi, \textit{Wading Through}, supra note 16, at 16 (same); Viscusi, \textit{Diminished Role}, supra note 14, at 95 ("product-specific insurance within the constraints of the tort system" involves greater administrative costs). A study by Tillinghast, an insurance industry consultant, came to the same conclusion. See Koretz, \textit{Litigation Cost is Rocketing—Its Efficiency Isn't}, \textit{Bus. Week}, Nov. 6, 1989, at 34.

\[^{64}\] "Of the $29 to $36 billion total national expenditure [on tort litigation] in 1985, plaintiffs received $21 to $25 billion in total compensation, or about $14 to $16 billion in net compensation, after deducting all their litigation costs." J. KAKALIK \& N. PACE, supra note 63, at 68.

\[^{65}\] See infra Part III(B)(2)(b) (describing difference between, and Priest's view of, activity-level effects and care-level effects of a liability rule).

\[^{66}\] The accidents that Priest refers to as "unpreventable" will be referred to in this Article as "care-unpreventable." "Unpreventable" accidents cannot be efficiently prevented through additional investments in care or reduced levels of activity, whereas "care-unpreventable" accidents cannot be efficiently prevented through additional investments in care alone. When Priest argues that the number of "unpreventable" accidents is independent of the liability rule, he means that the number of "care-unpreventable" accidents is independent of the liability rule. As argued below, there would be fewer accidents in an enterprise liability regime because of a decrease in activity levels. \textit{See infra} Part III(B)(2)(b).
theoretical matter, it is impossible to say whether a negligence regime or an enterprise liability regime would be cheaper to administer. The argument is straightforward. The administrative cost per case would be less in an enterprise liability regime than in a negligence regime, because in an enterprise liability regime courts must determine only whether the product caused the consumer’s injury, whereas in a negligence regime courts also have to determine whether the manufacturer or the injured consumer could have prevented the accident at least cost.6 Yet there would be a larger number of cases litigated in an enterprise liability regime, assuming as Priest does that both regimes left the same number of accidents unprevented. Analytically, it is unclear whether the “cost-per-case effect” would outweigh the “quantity effect.”68

A second shortcoming of Priest’s conclusions regarding administrative costs is that it is incomplete in that it fails to consider the total administrative costs of the regimes in question. The total administrative costs of any liability regime include the costs of negotiation, settlement, and litigation, as well as the costs of processing first-party and third-party insurance claims. Priest, however, focuses solely on the administrative costs of litigation, and then only on the administrative costs of litigating liability for care-unpreventable accidents.

Furthermore, the cost of administering the current tort system may not be an accurate measure of the costs of administering an enterprise liability regime. After all, the current regime is administered much like a negligence regime in which expensive cost-benefit analyses must be conducted.69 If courts fully adopted an enterprise liability rule (under which the administrative cost per case would be reduced) the total administrative costs of the tort system could well decline.

Additionally, adoption of a clear and stable liability standard would further reduce administrative costs by alleviating uncertainty among interested parties.

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68. The argument that this quantity effect will be significant depends on two debatable assumptions. First, it assumes that potential consumer-plaintiffs under a negligence regime can, without engaging the litigation process, know when the manufacturer was not the least-cost preventer of the accident. See infra text accompanying notes 71-73. Second, it assumes that there would be the same number of unpreventable accidents under a negligence regime as under an enterprise liability regime; otherwise, there could be a large enough number of injuries prevented under an enterprise liability regime—injuries that would not have been prevented under a negligence regime—to overcome the increased quantity of product-caused injuries that would be litigated under an enterprise liability regime. See R. POSNER, ECONOMIC ANALYSIS, supra note 67, at 164; Landes & Posner, Tort Law, supra note 1, at 550.

69. Priest, Accident Rate, supra note 47, at 195-96. The point is even stronger given that Priest proposes that courts adopt a “more rigorous formulation of cost-benefit standards for products liability law” which presumably would be more costly than our current regime to administer. Id. at 222; see also Epstein, The Political Economy of Product Liability Reform, 78 AM. ECON. REV. (PAPERS & PROCEEDINGS) 311, 313 (1988) (arguing that our current regime is very costly to administer largely because no legislative reform can overcome the special interests of both plaintiffs’ lawyers and defendants’ lawyers who benefit by maintaining the administrative complexity of the current common-law system).
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about future liability. Certain types of products liability cases would become routinized and their outcomes would become more predictable, so potential litigants would develop routine ways of disposing of claims. Fewer cases would go to trial and the cost of handling settled claims would decrease. Thus, insofar as our products liability regime has been expanding or changing unpredictably, the current costs of administering that regime overstate the cost of administering the same regime if it were stable. 70

Finally, the costs of administering first-party insurance include more than the costs of administering care-unpreventable accidents under a negligence regime. Because it is rarely clear whether an accident was care-unpreventable, courts are often called upon to decide this issue. 71 Some litigation costs can be properly characterized as a necessary investment in acquiring information. That is, litigation is often the only way for injured consumers to know whether the manufacturer could have cost-justifiably prevented the injury. 72 As a result, care-unpreventable accidents would involve substantial litigation and settlement expenses under a negligence regime, in addition to the expense of processing first-party insurance claims. 73 Priest's comparison, however, disregards the litigation costs under a negligence regime.

2. Damage Awards for Nonpecuniary Losses

The second source of the liability crisis, according to Priest, is that courts, by awarding damages for nonpecuniary losses, have forced upon consumers an undesirable insurance contract. 74 Yet Priest does not recommend that nonpecuniary-loss damage awards be prohibited altogether.


71. See J. HENDERSON & A. TWEIKSI, PRODUCTS LIABILITY: PROBLEMS AND PROCESS 78-79 (1987) ("The negligence standard is necessarily vague, and even reasonable persons can disagree over whether manufacturers have been negligent. And proof regarding what actually happened is frequently not available. Thus, trials are necessary . . . ."); Epstein, The Social Consequences of Common Law Rules, 95 HARV. L. REV. 1717, 1720 (1982) ("It is . . . rarely easy to identify the cheapest-cost avoider.").

72. Only after a consumer has filed suit does the consumer enjoy access—under the supervising power of the court—to information necessary to determine whether a manufacturer could have cost-justifiably prevented the injury. Rule 26(b)(1), for example, provides that "[p]arties may obtain discovery regarding any matter, not privileged, which is relevant to the subject matter involved . . . including the existence, description, nature, custody, condition and location of any books, documents, or other tangible things." FED. R. CIV. P. 26(b)(1). Rules 27, 30, 31, 33, 34, and 36 provide for the discovery of information to which a non-litigating consumer generally does not have access.

73. See infra notes 244-45 and accompanying text; see also Hanson & Logue, The First-Party Insurance Externality: An Economic Justification for Enterprise Liability, 76 CORNELL L. REV. 123, 169-70 (1990) (discussing the difficulty of determining negligence). Epstein has argued that "[t]here is no question that [enterprise liability] has advantages over the alternative negligence view of the subject. One factual issue is removed from consideration at trial, and the defendant has a clearer sense of the net expenses that it could incur from the product in question." Epstein, Unintended Revolution, supra note 1, at 2202.

74. See also P. HUBER, supra note 1, at 121-27, 137; S. SUGARMAN, supra note 39, at 39.
To understand Priest’s position, it is necessary to consider the different ways that nonpecuniary losses can be treated under a negligence liability rule. Applying any liability rule requires determining, first, who is liable for an injury and, second, if someone other than the victim is held liable, how much should be paid. Because Priest proposes a negligence standard, there are four approaches to nonpecuniary losses that he could possibly support. They are depicted in Table 1. Approach 1 would include nonpecuniary losses in determining whether a manufacturer was negligent (the “negligence determination”)—that is, it would count nonpecuniary losses as costs in the cost-benefit calculation to determine negligence—and it would include nonpecuniary losses in the damage award if a manufacturer were found to have been negligent. Approach 2 would also include nonpecuniary losses in the negligence determination but would exclude them from the measure of damages. Approach 3 would exclude nonpecuniary losses from the negligence determination, but would include them in the measure of damages if the manufacturer were found negligent. Finally, Approach 4 would exclude nonpecuniary losses from both the negligence determination and the calculation of damages. If courts ignore nonpecuniary losses either when determining negligence or when calculating damages, then manufacturers will not take nonpecuniary losses fully into account in their production decisions.\textsuperscript{75} Put slightly differently, if manufacturers are not held liable for all of the nonpecuniary losses that they can cost-justifiably prevent, then they will have suboptimal incentives to prevent

\textsuperscript{75.} See R. Cooter & T. Ulen, supra note 1, at 367.
Table 2

Deterrence Effects of Four Approaches in Table 1

<table>
<thead>
<tr>
<th>Approach</th>
<th>Probability of Being Held Liable</th>
<th>Size of Damage Award</th>
<th>Level of Deterrence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approach 1</td>
<td>Optimal</td>
<td>Optimal</td>
<td>Optimal</td>
</tr>
<tr>
<td>Approach 2</td>
<td>Optimal</td>
<td>Suboptimal</td>
<td>Suboptimal</td>
</tr>
<tr>
<td>Approach 3</td>
<td>Suboptimal</td>
<td>Optimal</td>
<td>Suboptimal</td>
</tr>
<tr>
<td>Approach 4</td>
<td>Suboptimal</td>
<td>Suboptimal</td>
<td>Suboptimal</td>
</tr>
</tbody>
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For this reason, courts can optimize manufacturer care only by placing on manufacturers the full costs of accidents, including the nonpecuniary costs. As Priest recognizes: “To obtain optimal incentives for injury prevention, a party that has violated a legal standard must pay full losses to the victim, including both pecuniary and non-pecuniary losses.”

Table 2 outlines the deterrence effects of the four approaches. Only Approach 1 would optimize deterrence. Approach 4 would be the least efficient because under Approach 4 manufacturers would too rarely be found negligent, and, for those cases in which they were found negligent, damages would be too low. Although it seems clear that Priest does not recommend Approach 4, he does not explicitly reject it. Instead, he suggests that courts can optimize manufacturer care by placing on manufacturers the full costs of accidents, including the nonpecuniary costs.

76. If markets were perfect, manufacturers would have optimal incentives to prevent nonpecuniary losses regardless of the liability standard. Even under a “no-liability” regime, manufacturers would make all efficient investments in product safety, so long as markets were perfect. That insight, however, does not bear on this discussion. The same point can be made regarding the treatment of pecuniary losses, yet not even Priest recommends that courts adopt a no-liability regime. If he believed markets were perfect he would presumably favor a no-liability regime over negligence: a no-liability regime would have zero administrative costs, and would create none of the adverse insurance effects that Priest believes our current regime creates. Priest must believe that market incentives, by themselves, are insufficient to ensure optimal deterrence.

77. Few tort scholars have enough faith in markets to argue on behalf of a no-liability regime. Even Chicago School legal economists such as William Landes and Richard Posner argue that negligence or strict liability is to be preferred to no-liability in this context. For a more complete discussion of this issue, see S. Croley & J. Hanson, Understanding Products Liability, supra note 1.

78. Priest, Insurance Crisis, supra note 19, at 1553; see also Priest, Modern Reform, supra note 17, at 16; Priest, Compensation, supra note 25, at 139.
2 or Approach 3,79 his choice between Approach 1 and Approach 4 is less obvious.

On one hand, consistent with Approach 4, Priest clearly believes that awarding damages for nonpecuniary losses has led to significant inefficiencies in the current regime. According to Priest, products have been withdrawn from the market because their manufacturers have been subject to strict liability for nonpecuniary losses and therefore have been forced to provide insurance that consumers do not demand.80 Priest writes:

[T]ort law third-party insurance provides coverage at excessive levels relative to consumer demand. On average, 47 percent of a tort law damage award represents coverage of pain and suffering. No consumers in the world, however, want (or are willing to pay for) insurance coverage of nonpecuniary pain and suffering. Pain and suffering does not affect the marginal value of wealth, the equalization of which is the purpose of insurance . . . .

If pain and suffering awards comprise almost half of modern tort judgments, then, for this reason alone, tort law insurance judgments are almost twice the magnitude that any consumer would prefer.81

Thus, Priest apparently believes that nonpecuniary-loss damage awards should be prohibited under the current regime.82

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79. When scholars discuss the question of whether nonpecuniary losses should be included or excluded, they generally consider only Approaches 1 and 4. Because no scholar has ever recommended that courts adopt Approach 2 or Approach 3, it is unlikely that Priest implicitly supports either of these approaches. Presumably, he would have stated such a novel proposal clearly if he had been chosen to support one of them. If he had supported Approach 2, he would have been careful to say that he wanted nonpecuniary losses to be included in the negligence determination; if he had supported Approach 3, he would have indicated that he wanted damage awards to include nonpecuniary losses but wanted courts to ignore nonpecuniary losses in making negligence determinations.

The reason for the distinction here between the negligence determination and the damages determination will become clear in Part III. See infra notes 174-82 and accompanying text.

80. Here again, Priest is joined by others. See P. HUBER, supra note 1, at 137 ("[T]he rate of exchange [between injuries and dollars] is quite indeterminate for pain and suffering and loss of society . . . . For precisely this reason, first-party insurance never covers such things . . . . The new rules thus demanded ever-increasing amounts of coverage for losses that no insurer could ever accurately assess in advance."); Trebilcock, Insurance Considerations, supra note 23, at 259 ("[T]he insurance rationale for the current liability system is . . . inefficient . . . because it provides forms of coverage that people would not voluntarily buy or be provided with in first-party insurance markets.").

It is argued below that consumers may in fact demand insurance for nonpecuniary losses. See infra Part III(B)(2)(a).

81. Priest, Liability Crisis, supra note 47, at 5; see also Priest, Understanding the Crisis, supra note 47, at 207-08 (making similar argument); Priest, Liability Costs, supra note 47, at 323 (same).

82. See Priest, Liability Costs, supra note 47, at 324; Priest, Modern Reform, supra note 17, at 37. Similarly, Priest argues that legislative efforts to reform products liability, including caps on nonpecuniary losses, "constitute only partial contributions toward solutions of the problems caused by modern tort law." The crisis will continue until these "issues are dealt with more systematically":

The insurance function must be excised from tort law altogether. None of the recent statutory reforms achieves that effect.

A cap on non-economic [i.e., nonpecuniary] damages, for example, does shift tort damage awards to more closely resemble levels of insurance purchased in first-party markets. In first-party markets, however, no one purchases any coverage of non-economic losses. Thus, even if non-economic damages in tort law are capped . . . ., tort law continues to provide a very
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On the other hand, Priest clearly sees that deterrence can only be optimized if manufacturers are required to compensate accident victims for both pecuniary and nonpecuniary losses. Priest therefore appears to propose a liability rule consistent with Approach 1. If a manufacturer could have prevented an accident (that is, if the accident was care-preventable), then it would pay all damages including nonpecuniary-loss damages; if the manufacturer could not have prevented an accident, then it would pay nothing. By taking this position, Priest can maintain his commitment to optimizing deterrence and avoid imposing a strict liability rule.\footnote{384. Priest advocates a cost-benefit negligence regime and contends that the pre-1960s negligence regime was not a cost-benefit negligence regime. Priest, Accident Rate, supra note 47, at 220-22. However, other scholars disagree. See, e.g., W. LANDES & R. POSNER, supra note 57, at 85-87; R. POSNER, ECONOMIC ANALYSIS, supra note 67, at 147-60. If they are correct, then Priest's proposed cost-benefit negligence system is equivalent to the old negligence regime.}

By taking this position, however, Priest also raises difficult questions regarding his explanation for the crisis. If he wants courts to award nonpecuniary-loss damages under his proposed negligence regime, how can he argue that courts should not have awarded them under the current regime? If it is true that liability insurance markets broke down in part because courts began awarding nonpecuniary-loss damages, how can we be confident that those markets would not suffer the same problems under a negligence regime?\footnote{83. Priest has emphasized his commitment to the deterrence goal of products liability law. See, e.g., Priest, Modern Reform, supra note 17, at 5 (“Much of the debate over tort law has involved accusations that those advocating tort reform are indifferent to the accident rate. There ought to be no grounds for battle on this point. An unquestioning commitment to the desirability of minimizing the accident rate still compels a drastic reorganization of the law.”); see also Priest, Accident Rate, supra note 47, at 221. Others agree that deterrence is the most important goal of the liability system. See, e.g., P. DANZON, supra note 22, at 9 (“[T]he primary economic rationale for tort liability is deterrence.”).}

Priest has taken this position, however, he argues that courts should not have awarded them under the current regime? If it is true that liability insurance markets broke down in part because courts began awarding nonpecuniary-loss damages, how can we be confident that those markets would not suffer the same problems under a negligence regime?\footnote{384. Priest advocates a cost-benefit negligence regime and contends that the pre-1960s negligence regime was not a cost-benefit negligence regime. Priest, Accident Rate, supra note 47, at 220-22. Yet on this point, too, other scholars have taken a different position. See R. EPSTEIN, supra note 1, at 83; R. POSNER, supra note 67, at 165 (“[T]he term strict liability is something of a misnomer here, because in deciding whether a product is defective or unreasonably dangerous in design or manufacture the courts often use a ‘hand formula’ approach, balancing expected accident costs against the costs of making the product safer.”); Calabresi & Klevorick, Four Tests for Liability in Torts, 14 J. LEGAL STUD. 585, 585 (1985) (“Taken literally, product defect would seem to imply liability for any and all injuries that are causally linked to the product . . . . Yet . . . , that is not the thrust of strict product liability.”); Landes & Posner, Products Liability, supra note 1, at 546 (“Much of what is called strict products liability really is negligence liability. . . . In these cases the analysis . . . is identical to that in negligence cases.”); Schwartz, Proposals, supra note 10, at 384-88; see also authorities cited supra at notes 14, 16 and text accompanying notes 186-96.}

More important, Priest's call for the adoption of his proposed negligence standard is somewhat confusing. On the one hand, he emphasizes that the standard he proposes is significantly different from the previous negligence standard, while, on the other hand, he argues that the liability 'crisis' was the consequence of courts' deviation from the previous negligence standard. The empirical phenomena that Priest argues constitute a 'crisis' are not per se evidence of a problem, if the previous negligence standard was not itself optimal. See P. Danzon, Second Look at Tort Reform, supra note 33, at 12. For examples of where Priest implies that the phenomena associated with the 'crisis' constitute evidence of a crisis, see Priest, Insurance Crisis, supra note 19, at 1522, 1567-68.}

substantial level of excess insurance coverage.

Similarly, limitations on punitive damages may reduce risk pool variance to some extent. In my view, however, it is inappropriate not only to retrain, but to prohibit, punitive damage awards in product liability and other tort contexts.
Priest could answer these questions only by stating explicitly the empirical assumption upon which his “crisis” explanation implicitly depends: Most nonpecuniary-loss damage awards made under our current regime have been for care-unpreventable accidents. However, to the extent that nonpecuniary-loss damage awards granted under the current regime have been for care-preventable accidents, they would also be granted under the cost-benefit negligence regime that Priest proposes. Priest’s proposed liability rule would significantly decrease the total amount of compensation awarded for nonpecuniary losses only if the current regime awards damages for nonpecuniary losses mainly in cases involving care-unpreventable accidents. If in fact Priest believes that the bulk of the nonpecuniary-loss damage awards have been for care-unpreventable accidents, then he is assuming by implication that our current regime has had little beneficial deterrent effect.

It may be helpful to make this point in slightly different terms. Priest argues that, for insurance reasons, manufacturers should not be liable for any nonpecuniary losses. But as he understands, optimal deterrence will often require that the nonpecuniary costs be imposed on the manufacturer. Any recent trend toward such an imposition is thus perfectly consistent with the

85. This implication follows from Priest’s assumption that “[when a manufacturer has made all practicable investments in the manufacturing process and in quality control, liability for remaining defects involves only insurance.” Priest, Accident Rate, supra note 47, at 209. Priest has expressed the empirical assumption that our current regime has had little beneficial deterrent effect as follows: “As is well known, manufacturers are very commonly held liable even though there was no effective alternative investment that could have been made to prevent the accident.” Priest, Modern Reform, supra note 17, at 12; see also Priest, Compensation, supra note 25, at 138 (“Since the mid-1960’s, the individual state courts have steadily expanded tort liability, especially corporate tort liability in contexts of product or service use, in order to provide a form of compensation insurance for consumers tied to the sale of the product or service.”); Priest, Insurance Crisis, supra note 19, at 1550; Priest, Understanding the Crisis, supra note 47, at 204; Priest, Accident Rate, supra note 47, at 222; Priest, Risk Control, supra note 47, at 222-23.

Priest and others calling for products liability reform tend to emphasize only the insurance justifications for legal doctrines that could instead be justified primarily on deterrence grounds. See Priest, Modern Reform, supra note 17, at 36 (“The only grounds that can justify absolute liability . . . are insurance grounds.”); Rea, Comment on Epstein, 14 J. LEGAL STUD. 671, 671-673 (1985) (criticizing Epstein for his one-sided analysis of products liability doctrines); Trebilcock, Comment on Epstein, 14 J. LEGAL STUD. 675, 676 (1985) (same). Indeed, even punitive damages can be justified on deterrence grounds. For Priest’s view of punitive damages, see supra note 82. In situations where the number of victims bringing suit is less than the number of individuals who actually suffer injuries due to a defendant’s activity—for example, where those injured have imperfect information about the link between the defendant’s activity and their injuries—punitive damages help maintain proper incentives for defendants. Moreover, what are nominally punitive damages might, at least in some cases, serve a compensatory function.

It appears that the Internal Revenue Service understands punitive damages in this way. The receipt of punitive damages constitutes income for tax purposes, unless the plaintiff-taxpayer received punitive damages arising out of a personal injury. When a plaintiff-taxpayer recovers punitive damages as well as damages for personal injury, the former, like the latter, are not taxed under I.R.C. § 104(a)(2). Otherwise, where a plaintiff taxpayer receives punitive damages arising out of an injury to property or in the antitrust context, punitive damages are considered income on the ground that they constitute windfall to the plaintiff-taxpayer. Compare Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), with Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983). See also Rev. Rul. 75-45, 1975-1 C.B. 47. Because the I.R.S. does not tax personal injury damages on the ground that such damages simply return the plaintiff-taxpayer to the status quo ante, and because the I.R.S. does tax punitive damages (where there is no personal injury) on the ground that such damages constitute a windfall gain for the plaintiff taxpayer, the I.R.S.’s approach to punitive damages in the personal injury context would be anomalous unless punitive damages in such cases were considered to serve, at least in theory, some compensatory purpose.
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goal of optimizing deterrence. Priest’s explanation for the liability crisis apparently overlooks the real possibility that most of the nonpecuniary-loss damage awards of our current regime could also have been awarded under a cost-benefit negligence rule. The recent changes in third-party insurance markets and consumer product markets that Priest characterizes as a “crisis” might well have still occurred. To substantiate his characterization, Priest would have to show that manufacturers have been held liable for nonpecuniary losses most often for accidents that were care-unpreventable. But Priest offers no such empirical demonstration. And such a demonstration would not be easily made, not only because the empirical data related to this issue are difficult to obtain, but also because our current regime, as many scholars have concluded, is largely equivalent to a negligence regime (that is, manufacturers are held liable only for initially preventable accidents). Absent support for his implicit assumption, it is not clear why Priest objects to the fact that courts have included nonpecuniary awards in products liability damages.

3. The Moral Hazard Consequences of Manufacturer-Provided Insurance

The third source of the liability crisis according to Priest is that manufacturer-provided insurance, unlike first-party insurance, cannot cope with the standard insurance perils of adverse selection and moral hazard. Adverse selection occurs when the expected accident costs of new entrants into an insurance pool exceed those of the average pool member, and therefore exceed the premium charged to all members. In effect, the process of adverse selection causes relatively low-risk members to pay a larger subsidy to the relatively high-risk members of the pool. Part II below explores in detail Priest’s arguments concerning adverse selection. This subsection focuses on the other insurance peril, moral hazard.

“Moral hazard” is the term used to describe the tendency of insured individuals to engage in risky activities that they would avoid but for the fact

86. Indeed, recent evidence suggests that products-liability awards have actually undercompensated injured consumers for nonpecuniary losses. See, e.g., Viscusi, Diminished Role, supra note 14, at 83-85 (“Tort liability is often not an efficient deterrent because tort awards are less than private valuation of risk.”); id. at 95-97 (“The actual value of court awards and settlements is ... often less than the actual losses suffered by the victim.”).

87. See supra note 84. To be sure, one can point to cases in which courts use the language of “strict liability,” but such language does not imply that those cases would have been decided differently under a negligence regime. See Landes & Posner, Products Liability, supra note 1, at 546.

88. Epstein, Insurance Market, supra note 1, at 646.

89. Priest, Modern Reform, supra note 17, at 16-17; see also P. HUBER, supra note 1, at 136-37 (changes in the law have reduced insurers’ ability to combat adverse selection, “every insurer’s nightmare”); Epstein, Insurance Market, supra note 1, at 653 (“The problem of moral hazard is all pervasive.”); Schwartz, Proposals, supra note 10, at 405 (“The problems of moral hazard, adverse selection, and cross-subsidization that accompany manufacturer-supplied insurance make strict liability seem less desirable.”); Trebilcock, Insurance Considerations, supra note 23, at 246 (“Imposing [absolute] liability ... would ignore moral hazard considerations to which private insurers would be sensitive. It would also ignore adverse selection considerations ... ”).

90. High-risk individuals are those individuals for whom expected damages are greatest, because the probability of an accident is high, or because damages in the event of an accident will be high, or both.
that they are insured. Insofar as insurance cushions insureds from the full costs of their risky activities, insureds will be less reluctant to engage in those activities.\footnote{For a more complete explication of these phenomena, see Hanson & Logue, supra note 73, at 138-39.}

To Priest and others, it is clear that first-party insurance is superior to enterprise liability \textit{qua} insurance in coping with moral hazard.\footnote{See authorities cited \textit{supra} note 89.} According to Priest, under a system of enterprise liability moral hazard would abound because "[t]ort judgments never incorporate the deductibles and coinsurance that typify first-party insurance arrangements, under which victims bear a share of costs.\footnote{ Priest, \textit{Understanding the Crisis}, \textit{supra} note 47, at 208. A deductible is a provision requiring an insured to pay up to some set amount of her accident expenses, say, the first $175, before the insurer will pick up all or some fraction of the remainder. Coinsurance, on the other hand, is a provision under which the insurer agrees to pay only a fraction, say, 75\%, of an insured's total losses, whatever the amount of those losses might be.}"\footnote{ K. ABRAHAM, DISTRIBUTING RISK 15 (1986); Danzon, \textit{Tort Reform}, \textit{supra} note 33, at 526.} Deductibles and coinsurance, by requiring insureds to include some portion of the accident costs in their decision calculus, help to align the incentives of insureds and insurers and thereby to mitigate moral hazard.\footnote{ Priest, \textit{Modern Reform}, \textit{supra} note 17, at 19 ("[U]nlike all forms of first-party insurance, third-party tort law insurance never incorporates victim deductibles or coinsurance to constrain moral hazard. Victim moral hazard is just as serious a problem in third-party as in first-party contexts. It follows that third-party premiums will be necessarily higher than first-party premiums for the same level of coverage."); Priest, \textit{Insurance Crisis}, \textit{supra} note 19, at 1553 ("Deductibles and co-insurance are features of every first-party insurance contract. Third-party insurance through the tort system, in contrast, never incorporates deductibles or co-insurance to control victim moral hazard."); Priest, \textit{Compensation}, \textit{supra} note 25, at 139 (making substantially the same argument); Priest, \textit{Insurance Crisis}, \textit{supra} note 19, at 1555 ("[U]nder third-party insurance provided through tort law, there is little reason for the beneficiary of insurance—the tort plaintiff—to engage in difficult decisions about appropriate levels of medical treatment . . . . The tort plaintiff . . . loses nothing by requesting (or asserting as essential) all available advanced methods of medical treatment regardless of cost."); see also Schwartz, \textit{Proposals}, \textit{supra} note 10, at 405 (making similar argument); Viscusi, \textit{Wading Through}, \textit{supra} note 16, at 587 (same).} And because, according to Priest, manufacturer-provided insurance does not incorporate deductibles or coinsurance, it provides a higher level of compensation than does first-party insurance and thus exacerbates the moral hazard problem under manufacturer-provided insurance.\footnote{ Priest, \textit{Insurance Crisis}, \textit{supra} note 19, at 1556. It is from this calculation that Priest concludes that "tort-law insurance provides much more coverage than first-party insurance—2.34 times as much, on average, for the identical injury." Priest, \textit{Understanding the Crisis}, \textit{supra} note 47, at 207. Priest assumes, however, that the only form of insurance from which consumers receive compensation in the event of an accident is health insurance. But accidental injury insurance, which consumers buy to supplement their health insurance, is not uncommon. \textit{See}, e.g., All American Life Insurance Company's Accidental Death and Dismemberment Insurance, Master Policy No. ADD-1 (on file with authors); Mutual of Omaha's Travel Accident Insurance, Policy Form T20T [hereinafter Travel Accident Insurance plan] (on file with...} To illustrate this point, Priest calculates the percentage of "excess coverage" that tort law purportedly provides. Following one empirical study, for the injury represented in the median tort judgment, Priest estimates that had the victim been compensated through first-party insurance, the victim would have received a total of $79,916. This, Priest claims, "is the amount for which the victim \textit{ex ante} was willing to pay. In contrast, third-party tort insurance provided $187,000 coverage which is 2.34 times greater than the first-party amount."\footnote{ Priest goes on to argue that, even if tort awards are reduced by...}
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thirty percent to cover attorneys’ fees, the above award “would still be 1.64 times the comparable first-party insurance award.”

But even that figure overstates the relative amount of compensation injured consumers received through tort-law mechanisms vis-à-vis first-party mechanisms. First of all, the tort judgments that Priest cites for purposes of comparison may significantly exceed the compensation actually paid by manufacturer-defendants to the median injured consumer. This is true for several reasons. First, only a small percentage of product injuries are litigated to a judgment. This fact is important because the cases most likely to be litigated to a judgment are those with the largest damages. Moreover, claims are likely to be settled at an amount much lower than the expected damage award, especially in categories for which the award is highly variable.

Priest’s sample for estimating the amount of compensation received by injured consumers from manufacturers therefore seems to be biased upward.

Priest’s sample may be biased for other reasons as well. Trial courts and appellate courts overturn jury awards and defendants sometimes have

authors). Moreover, proceeds from life insurance policies are sometimes paid to the beneficiaries of injured consumers. Priest’s figures may thus underestimate the compensation received by injured consumers under first-party insurance.

97. Priest, Insurance Crisis, supra note 19, at 1556.

98. Pollock & Felsenthal, Federal Civil Cases Rarely Reach a Trial, Wall St. J., June 27, 1990, at B6, col. 1 (“Almost 95% of all private civil cases filed in federal courts never reach trial, ending instead in settlements or other pretrial dispositions according to a study by Rand Corp. Moreover, the percentage of cases tried appears to be declining steadily.”); Peterson & Priest, supra note 47, at 363 (“Of many as 95 percent of filed lawsuits are either settled or dropped without reaching trial.”). Of the two percent of cases that are litigated, only five percent are litigated to a verdict. See Litan, Swire & Winston, supra note 15, at 7.

Describing typical patterns of claim disposition in medical malpractice and products liability cases, Danzon states: “About 43 percent of the claims were dropped without payment, while 50 percent were settled out of court with an average payment to the plaintiff of $26,000. Of the remaining 7 percent that were litigated to verdict, the plaintiff won roughly one in four, with an average award of $102,000.” P. Danzon, supra note 22, at 32; see also id. at 37 (“Claims that are tried to a verdict are predicted to involve atypically large dollar amounts and more uncertainty about liability. Consequently, this small subset of claims will be an unreliable basis for predicting potential verdicts for cases actually settled or for evaluating how well the system functions for the great majority of cases that are settled out of court.”); id. at 51 (“The cases that are actually litigated to a verdict constitute a small, atypical subset, ‘self-selected’ to that stage of disposition precisely because the outcome was unpredictable to the litigants, the potential award was large, and the evidence for the plaintiff was weak. Thus we get a very biased impression of the operation of the malpractice system from observing the minority of more visible cases that are litigated to a verdict rather than the great majority of cases that are settled out of court.”).

99. Cf. Priest, Insurance Crisis, supra note 19, at 1557 n.151 (explaining that, all else equal, the larger the claim, the more likely it is that the claim will be “filed, pressed and successfully recovered.”)

100. Viscusi,Products Liability Litigation with Risk Aversion, 17 J. LEGAL STUD. 101, 107-08 (1988) [hereinafter Viscusi, Risk Aversion]. This analysis does not even take account of the fact that consumers are probably risk averse—especially with regard to large nonpecuniary losses—which would probably lower settlement amounts further relative to expected damages. See Schwartz, Proposals, supra note 10, at 379; see also Viscusi, Risk Aversion, supra, at 118 (risk-averse claimants often settle for less than their expected award); cf. Galanter, The Day After the Litigation Explosion, 46 MD. J. LEGAL STUD. 3, 8-9 (1986) (“Wary of risks, delays, and costs, litigants do not act as if propelled by an unappeasable appetite for contest or public vindication. For plaintiffs and defendants alike, litigation proves a miserable, disruptive, painful experience. Few litigants have a good time or bask in the esteem of their fellows—indeed, they may be stigmatized. Even those who prevail may find the process very costly.” (citations omitted)).
inadequate resources with which to pay damages. Consequently, the amount that is ultimately paid by defendants is roughly thirty percent less than the amount originally awarded at trial court. Because Priest uses trial court statistics, he may overstate by thirty percent the damages that manufacturers actually pay to injured consumers.

Finally, Priest’s sample of litigated cases does not reflect the fact that tort claimants must, ex ante, take into account the probability that they will lose their cases. Priest’s statistics reflect only the damages paid to injured consumers who won in court. But a large percentage of injured consumers who litigated their cases to a verdict lost them. Indeed, Priest has noted that from 1960 to 1979 plaintiffs won in only thirty-eight percent of products liability trials. The other sixty-two percent received nothing from manufacturers.

Assuming more realistically that the median tort claimant in Cook County had hired a lawyer on a thirty-three percent contingency fee, that there had been thirty-eight percent chance of the claimant’s winning in the lower court, and that any lower court awards were ultimately reduced by thirty percent (either because they were overturned or because the defendants were judgment proof), the claimant’s expected third-party tort insurance coverage, prior to trial, would have been $32,830. This estimate indicates that the expected coverage under third-party insurance is less than half of the comparable coverage under first-party insurance. Because it is based on a sample of cases litigated to a judgment (and does not include cases in which consumers settled or failed to litigate), this estimate may overstate the average amount received by injured consumers from manufacturers.

Priest concludes that the moral hazard problem is more severe under manufacturer-provided insurance because “[t]ort law insurance coverage levels are in the range of 64% to 134% greater than first-party coverage levels.” As argued here, however, the moral hazard problem may well be less severe under manufacturer-provided insurance: first-party coverage levels may be 143% greater than tort law insurance coverage levels.

reductions averaged 7% for verdicts over $1,000,000, reductions averaged 40% for all cases where there was a reduction, the reduction averaged 47% of jury verdict; see also P. Danzon, Second Look at Tort Reform, supra note 33, at 5 (there is a “greater percentage [of] reductions in large awards” than there is in small awards).

102. It also seems safe to suppose that defendants would be less likely to be able to pay damage awards when all else equal, those damage awards are particularly large.


104. For a more complete discussion of this point, see Hanson & Logue, supra note 73, at 143-44.

105. Peterson & Priest, supra note 47, at 365 (citing Broder, Characteristics of Million-Dollar Awards: Jury Verdicts and Final Disbursements, 11 JUST. SYSS. J. 353 (1986)).

106. (.67)(.701.38($187,000)) = $32,830.

107. See supra notes 98-100 and accompanying text.

108. Priest, Insurance Crisis, supra note 19, at 1556.


It has been assumed throughout this Section that first-party insurance claimants do not incur legal expenses to secure their compensation. However, Priest emphasizes that in practice first-party insurers sometimes contest insureds’ claims, causing the insureds to pay the costs of litigation or settlement. See Priest, Insurance Crisis, supra note 19, at 1556. Thus Priest recognizes that injured plaintiffs incur litigation costs that may serve to limit the amount of manufacturer-provided compensation and thereby mitigate moral
C. Summary of Part I

To summarize, Priest and others believe that much of the insurance crisis stems from three differences between first-party insurance and manufacturer-provided insurance: (1) the administrative cost of manufacturer-provided insurance is higher than that of first-party insurance; (2) manufacturer-provided insurance, unlike first-party insurance, compensates injured consumers for pain and suffering and other nonpecuniary losses; and (3) manufacturer-provided insurance compensates claimants in full, without requiring them to pay any deductibles or copayments, and therefore heightens the moral hazard problem. Consequently, manufacturer-provided insurance supposedly "provides coverage at excessive levels relative to consumer demand" and therefore should be abandoned in favor of first-party mechanisms. Part I challenged each of these purported differences between first-party and manufacturer-provided insurance.

But there remains, according to Priest, a much more serious problem with manufacturer-provided insurance. This problem stems from the fact that "it is provided in a manner that makes it extremely difficult for the insurer to segregate high-risk insureds in the underwriting process." Because of that difficulty, he argues, manufacturer-provided insurance is plagued by adverse selection and unravelling. This "unravelling theory" constitutes Priest's most important contribution to the products liability literature. Part II challenges Priest's unravelling theory and lays some of the groundwork for the alternative "internalizing theory" that will be presented in Parts III and IV.

hazard. But he argues that these costs are analogous to the costs incurred by consumers in bringing first-party insurance claims. He concludes that even taking litigation costs into account, tort law insurance provides excessive compensation relative to first-party insurance. This conclusion ignores two points.

While litigation costs do exist under first-party insurance, it seems clear that they are lower than those that exist under a third-party tort system. When a first-party claimant files for compensation the insurer typically pays its portion of the bill without requiring the insured to litigate. Indeed, insurers sometimes compensate insureds even when they are not bound by contract to do so. See L. Ross, supra note 70, at 233-42. Insurance companies, interested in maintaining their "good hands" reputations, have incentives to avoid contesting insureds' claims. See id.; R. Ellikson, Order Without Law (forthcoming 1991). In contrast, the tort system is adversarial by design. Unlike the insurance claimant, the tort claimant must be prepared to prove at least that the defendant in question manufactured the offending good and that the good in question caused the injury. These burdens introduce a need for legal counsel and decreased likelihood of receiving compensation.

Moreover, to the extent that the litigation costs accompanying first-party insurance are substantial, these costs must be taken into account when comparing the administrative costs of a first-party scheme to those of a third-party scheme. Either these first-party legal expenses are so trivial that they should be ignored entirely, or they are sufficiently significant that they should be included in estimates of the administrative costs of the first-party system. In Priest's analysis, however, these costs are minimized when administrative costs of first-party insurance are measured, but emphasized when the copayment features of first-party insurance are measured.

110. Priest, Liability Crisis, supra note 47, at 6.
111. Id. at 7.
II. The Unravelling of Risk Pools

A. Introduction to Part II: Priest’s Principal Contribution

To begin, it is necessary to review Professor Priest’s influential explanation of how risk pools have unraveled. According to Priest, while the expansion of tort liability precipitated the crisis, “what has devastated commercial insurance markets is not simply the increase in tort claims but one particular aspect of that increase”: adverse selection.112 In Priest’s view, “[t]he varied phenomena of the recent liability crisis are all manifestations of the effects of adverse selection.”113 He writes:

Increases in risk correlation alone do not explain why insurers have reduced levels of insurance coverage including the refusal to offer coverage at any premium in some commercial casualty lines. Similarly, increases in insurance premiums cannot fully explain why providers have removed products and services from the market. . . . [A]dverse selection in both consumer and provider insurance pools, however, does explain these and other phenomena of the insurance crisis.114

Priest argues that the expansion of liability led to the unravelling of both consumer risk pools and manufacturer risk pools.115

Priest’s argument, in brief, is that the inclusion of nonpecuniary losses in damage awards not only raised the average expected costs of members of risk pools but, more importantly, also increased the variance of risks among members within those pools. Higher variance, in turn, heightened the propensity of those pools to unravel. Low-risk members exited the pools because their premiums—reflecting the average expected losses of each pool—were too high. In response, insurers raised premiums to cover the higher average expected losses of the pools’ remaining members. This increase, however, caused the new low-risk members to exit the pool, thereby necessitating another premium increase, and so on. Priest attempts to demonstrate the prevalence of the effects of unravelling in both consumer and manufacturer risk pools, and hence to establish “that contemporary tort law has restricted rather than expanded insurance availability.”116 The following two sections scrutinize the various components of Priest’s theory of the unravelling of consumer risk pools (Section B) and manufacturer risk pools (Section C).

112. Priest, Understanding the Crisis, supra note 47, at 198.
113. Priest, Liability Crisis, supra note 47, at 6.
114. Priest, Insurance Crisis, supra note 19, at 1563.
115. Id. at 1550-53.
116. Id. at 1550.
B. The Unravelling of Consumer Risk Pools

1. Two Versions of the Consumer Risk Pool Unravelling Story

Priest’s presentation of the unravelling of consumer risk pools seems to take two forms—a weaker, more conventional version and a stronger, more original version. The weaker version employs the classic view that asymmetric information between manufacturers and consumers led to the unravelling of consumer risk pools. Reacting to an increase in variance within consumer risk pools brought about by expanded manufacturer liability, low-risk consumers were unwilling to pay the larger cross-subsidies for the benefit of their high-risk counterparts. Accordingly, they exited consumer pools and thereby caused those pools to unravel.

This version of the unravelling theory has an important shortcoming. For adverse selection to occur, consumers must know both how much risk they present as well as how much risk is presented, on average, in the consumer risk pool for any given product. Without such knowledge, high-risk consumers would not know enough to self-select into pools where they pose above-average risk. And low-risk consumers would not be aware that they were cross-subsidizing high-risk consumers and therefore would not respond by exiting the pool. Put simply, consumers must know whether they are the benefactors or the beneficiaries of cross-subsidies in a consumer risk pool. It is unlikely, however, that consumers have such information.

Priest can avoid this criticism by arguing instead that the unravelling of consumer risk pools is due to nothing more than consumers’ reactions to changes in product prices. This version of the unravelling story proceeds as

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118. See id. at 489-90 (explaining that unravelling depends on asymmetric information); see also Epstein, Insurance Market, supra note 1, at 651; Alan Schwartz, A Theory of Loan Priorities, 18 J. LEGAL STUD. 209, 226-28 (1989) (presenting story of adverse selection based on asymmetric information.).

It is possible that there has been an increase in the variance of the size of actual damage awards (“ex post variance”). But for unravelling to occur, there also must have been an increase in the variance of expected damage awards from consumers’ ex ante perspectives (“ex ante variance”). Otherwise, consumers would have no reason to exit or to adversely select into risk pools. Consumers’ motivations for exiting risk pools and for adversely selecting into risk pools depend in part upon their comparisons between the prices they must pay for insurance and the awards they would expect to receive in the event of an accident. Without an increase in ex ante variance, all consumers would expect to receive the average damage award in the event of an accident, and ex post variance would have no effect on consumer behavior. Priest has not explained why there has been an increase in the variance of consumers’ expected damage awards.

Although Priest’s analysis may accommodate more than one interpretation, his discussions of unravel-ling in consumer risk pools suggests that he has in mind the second version of the unravelling story and not the first. Perhaps he adopts the second version to avoid basing conclusions on the strong assumption that consumers are asymmetrically informed. In any case, both versions depend upon several dubious empirical assumptions. For simplicity, this section focuses on the second version. Nevertheless, the same or similar criticisms apply to the first version as well.
follows. Because of expanding liability rules, manufacturers were forced to raise the prices of their products in order to cover new liability costs. But once manufacturers raised prices, the products were no longer worth their prices to low-risk consumers, who were more sensitive to price increases than were high-risk consumers. Low-risk consumers therefore exited product pools. In response, manufacturers were forced to raise prices again, this time in order to reflect the higher average expected loss of those who remained in the pool. But when manufacturers increased prices again, those who became the lowest-risk members of the pool after the departure of the first group now exited for the same reason. The cycle continued; the pool unravelled.

2. Dubious Empirical Assumptions

The empirical assumptions upon which Priest's unravelling story depends include the following: (i) as courts began increasing damage awards, there was an increase in the variance of expected products liability awards across consumers; this occurred because (ii) there is a positive correlation between consumers' levels of income and the size of consumers' expected pecuniary loss awards, and because (iii) there is a positive correlation between consumers' levels of income and the size of consumers' expected nonpecuniary loss awards; and finally, (iv) manufacturers could not prevent adverse selection and unravelling because manufacturers cannot adequately segregate consumers into different risk pools according to the different degrees of risk consumers pose. These assumptions are examined in turn.

Priest claims that the variance in expected risks presented by consumers increased as a result of expanding liability rules. To support this claim he makes the following argument:

The increase in the level of insurance coverage from the shift to the third-party tort mechanism is not likely to be uniform over all cases. The empirical observation that pain and suffering awards constitute 47% of total damages is an average figure. Pain and suffering and other nonpecuniary amounts comprise a much higher proportion of large damage judgments than of small damage judgments. For this reason, risk pool variance is likely to be greater under third-party tort insurance than under first-party insurance.

120. As explained below, Priest claims that low-income consumers tend to be more sensitive to price changes and also tend to be low-risk members of consumer risk groups. Thus, as price increases, low-income (that is, low-risk) consumers are the first to withdraw from the pool. See infra notes 121-35 and accompanying text.

121. Priest, Insurance Crisis, supra note 19, at 1557.
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Priest offers no empirical support for his contention that nonpecuniary-loss damages comprise a greater proportion of large damage judgments. However, even if his contention is accurate, an increase in the variance of damage judgments would have an effect on the variance of expected awards in risk pools only if there is a correlation between some characteristic, X, possessed by each consumer and the size of his or her expected damage awards. To provide this necessary characteristic, Priest asserts that high-income consumers receive disproportionate amounts of both pecuniary- and nonpecuniary-loss damage awards relative to low-income consumers. That is, Priest assumes that there is a positive correlation both between consumers' income levels and the size of their pecuniary-loss damage awards, and between consumers' income levels and the size of their nonpecuniary-loss damage awards. For Priest, then, X is income. Because this income-damages correlation is the source of greater variance within consumer risk pools, his unravelling story depends entirely upon it.

Damage awards for pecuniary losses consist primarily of compensation for medical expenses and for lost income. With respect to the former, it is not clear that there is a positive correlation between a given consumer's income and the amount of damages that consumer receives for medical expenses. While there may be evidence that suggests that, in general, high-income individuals spend more on medical care than do low-income individuals—that is, that medical care is a normal good—it seems doubtful that this generality applies in the products liability context. First, it seems that emergency medical care would account for a significant portion of medical expenses for injured victims of product-caused accidents. And, in that setting, it is less likely that injured consumers would make carefully calculated spending decisions about how much medical treatment to purchase, or, indeed, that they would be given much choice. Second, where product-caused injuries require longer-term medical treatment for which manufacturer-defendants pay prospectively, it seems unlikely that juries would award higher damage awards for such care to high-income consumers than they would to low-income consumers.

122. See P. Danzon, supra note 22, at 40 ("It is impossible to determine whether the courts tend to award proportionately greater non-economic damages in cases where economic losses are greater."); id. at 57 ("Compensation for pain and suffering increases less than in proportion to economic loss . . . .").
123. See supra note 119.
124. Priest, Insurance Crisis, supra note 19, at 1558-59 ("The largest items of damages in most third-party personal injury contexts, especially those involving permanent disability, are lost income and pain and suffering, which are highly correlated with individuals' expected income streams.").
125. See infra note 127.
126. Cf. A. Enthoven, Health Plan 8 (1980) (suggests that emergency medical care is atypical inasmuch as patients have little discretion with regard to the timing or type of care they receive).
127. If it is true that even in the products liability context low-income consumers spend less on medical care than do high-income consumers, that fact supports the argument above that moral hazard is no more severe under manufacturer-provided insurance than it is under first-party insurance. Priest argues that "under third-party insurance provided through tort law, there is little reason for the beneficiary of the insurance—the tort plaintiff—to engage in difficult decisions about appropriate levels of medical treatment. . . . The tort plaintiff . . . loses nothing by requesting (or asserting as essential) all available advanced
With respect to the supposed correlation between income and damage awards for lost income, the assumption that expected pecuniary awards would correlate positively with consumers' incomes seems plausible, given that lost wages often constitute a substantial portion of economic damages. As an empirical matter, however, this assumption finds surprisingly little support. 128 Jury awards do not seem to be positively correlated with income. Perhaps juries implicitly apply a reasonable-person standard when calculating the size of damage awards. 129 Whatever the explanation, the assumption that income correlates with pecuniary awards appears to be incorrect.

The assumption that there is a positive correlation between income and nonpecuniary-loss damage awards is less explicable. According to Priest,

"[T]he liability insurance premium tied to the sale of a product or service must be set according to the average expected liability payout. Tort judgments comprise medical expenditures, which are typically greater for high income patients; past and future lost income; and damages representing pain and suffering, which are highly correlated with lost income. The high correlation of these damage elements with income, however, means that the premiums set equal to the average damage payout will undercharge high income consumers and overcharge low income consumers. The provision of liability insurance tied to the sale of products and services requires the low income to subsidize the high income."

Again, by connecting nonpecuniary losses with lost income in this way, Priest can argue that members of consumer risk pools with low expected costs are those with low incomes. But there is no reason to believe that for a given injury low-income consumers would receive lower nonpecuniary-loss damage awards than would high-income consumers. And Priest provides no evidence in support of this claim. He argues that pain and suffering awards correlate with a plaintiff's income solely on the grounds that "it is typically sustained...

methods of medical treatment regardless of cost." But according to his argument regarding the correlation of tort awards and income, an injured consumer's decision about how much medical care to purchase does not seem to be affected significantly by the expectation of being reimbursed for medical expenses through tort law. Otherwise, low-income consumers would also demand top-quality medical care no matter the price. 128 Cf. P. DANZON, supra note 22, at 31 ("[T]he National Association of Insurance Commissioners concluded from their analysis of malpractice claims that there is no statistically significant relation between the amount paid to plaintiffs and their tangible or 'economic' loss (wage loss; medical and other expenses)."

(citation omitted)); id. at 40-42 ("We found no strong statistical evidence . . . that awards are related to the actual earnings of the plaintiff prior to the injury . . . [T]his suggests that juries tend to disregard the intent of the law to place a higher value on lives with higher earning power.").

129. See also infra notes 219-22 and accompanying text.

130. Priest, Puzzles, supra note 47, at 502 (footnote omitted) (emphasis added); see also Priest, Modern Reform, supra note 17, at 17 ("Tort law damages are dominated by lost income and by pain and suffering, which is highly correlated with lost income. The expected damage recovery of a low-income . . . individual is substantially less than that of a high-income . . . individual. Thus, the poor and low-income are the low-risk members of tort law insurance pools.").
job loss, rather than short though intense hospital expense, that signals disruption of the victim's life."\textsuperscript{131} This argument, however, is unpersuasive. First, Priest provides no support for the claim that sustained job loss "signals" disruption of a plaintiff's life more than a short but intense hospital stay would. Nor does he provide support for the implied premise that pain and suffering awards are based on "disruption" of a victim's life. But, more important, assuming there were such support, Priest's argument does not lead to the conclusion that pain and suffering losses correlate with a person's \textit{income} at the time of the accident. At most, the argument leads to the conclusion that, for low-income and high-income consumers alike, damage awards for lost income will correlate with damage awards for nonpecuniary damages. In short, Priest offers no reason to believe that, for a given injury, low-income consumers would receive lower nonpecuniary-loss damage awards than high-income consumers would.

Indeed, if, as Priest argues, it is true that high-income consumers spend more on medical care even in the products liability context,\textsuperscript{132} it seems likely that greater expenditures on medical care would, all else equal, lead to more effective medical care and ultimately to faster and more complete recovery for injured parties. If that is true, then high-income consumers would tend to experience less pain and suffering than would low-income consumers, who will spend less on medical care. If so, pain and suffering damages will correlate negatively with a victim's income.

Another empirical assumption necessary to support Priest's unravelling story is that manufacturers cannot adequately segregate consumers into risk pools.\textsuperscript{133} Only to the extent that manufacturers cannot distinguish among

\begin{itemize}
  \item \textsuperscript{131} Priest, \textit{Understanding the Crisis}, supra note 19, at 210; see Priest, \textit{Risk Control}, supra note 47, at 225.
  \item \textsuperscript{132} See supra notes 125-27 and accompanying text.
  \item \textsuperscript{133} According to Priest, under an enterprise liability regime, adverse selection would abound because manufacturers cannot segregate consumers according to the consumers' expected damages:

  It is very difficult for providers to segregate risk in the insurance offered through tort law. First-party insurers, through the insurance application process, obtain large amounts of information about individuals which allows substantial risk segregation. For example, in the context of insuring injuries from auto accidents, first-party insurers create risk pools according to the driver's age, driving level, and by moving violation and accident experience. None of these distinctions, however, can be implemented by the third-party auto manufacturer providing insurance for non-preventable accidents at the price of the auto. Tort law insurance must be provided indiscriminately, at the same premium to high-risk and low-risk alike.

  Priest, \textit{Modern Reform}, supra note 17, at 16-17; see also Priest, \textit{Insurance Crisis}, supra note 19, at 1557 (first-party insurers can "define risk pools of very narrow scope"); Priest, \textit{Compensation}, supra note 25, at 130 (first-party auto insurers segregate insureds efficiently); \textit{id.} at 140 ("Finally, and most seriously, insurers face substantially greater difficulty in segregating risks to increase insurance availability in third-party tort than in first-party insurance contexts"); first-party insurers implement a host of distinctions, manufacturers can implement "none."); Priest, \textit{Modern Reform}, supra note 17, at 17 (same); Priest, \textit{Understanding the Crisis}, supra note 19, at 208-09 (same).

  Priest argues further that because first-party insurers can segregate risks better than manufacturers can, enterprise liability also has adverse distributional effects. See Priest, \textit{Insurance Crisis}, supra note 19, at 1558-60, 1585-86; Priest, \textit{Liability Crisis}, supra note 47, at 7; Priest, \textit{Compensation}, supra note 25, at 1040-41; Priest, \textit{Puzzles}, supra note 47, at 502. But see Epstein, \textit{Unintended Revolution}, supra note 1, at 2215-16 (reviewing Priest's argument about distributional effects but concluding that "generalizations
consumers according to the different risks they pose can consumers exploit information asymmetries. It is unrealistic, however, to assume that manufacturers cannot design, package, and market their products to ensure that the products are consumed by individuals with fairly homogeneous risk-related characteristics. Moreover, modern marketing techniques, including coupons and consumer rebates, are easily and often directed at particular subgroups of consumers and have the effect of offering the same products to different consumers at different prices.

3. Theoretical Shortcomings of the Unravelling Theory

Even if the strong empirical assumptions required by the unravelling theory were all true, there remain several theoretical shortcomings of Priest's presentation of the unravelling of consumer risk pools.

First, his analysis conflates the meanings of "low-risk" and "low-income," and likewise the meanings of "high-risk" and "high-income." Were Priest correct that there is some positive correlation between income and damage awards, it does not follow that all low-risk consumers are low-income consumers and all high-risk consumers are high-income consumers. A consumer's "risk" has to do not only with the size of a consumer's expected damage award in the event of an accident, but also with the probability of an accident occurring in the first place. There is no reason to assume that all consumers are equally accident-prone. Consider the matrix in Table 3, which grants the assumption that income is positively correlated with the size of damage awards. In this matrix, there are four categories of consumer riskiness. The most risky consumers are those with high incomes and high probabilities of being injured in a product-caused accident (Category 1). The least risky consumers are those with low incomes and low probabilities of being in an accident (Category 4). Low-income, high-probability consumers (Category 2) and high-income, low-probability consumers (Category 3) fall somewhere in the middle.
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Table 3

Four Categories of Consumer Riskiness

<table>
<thead>
<tr>
<th>Probability of Accident</th>
<th>Consumer’s Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>High Category 1</td>
</tr>
<tr>
<td></td>
<td>Low Category 2</td>
</tr>
<tr>
<td>Low</td>
<td>High Category 3</td>
</tr>
<tr>
<td></td>
<td>Low Category 4</td>
</tr>
</tbody>
</table>

Distinguishing between low-probability and high-probability high-income consumers, and similarly between low-probability and high-probability low-income consumers blunts Priest’s explanation of consumer risk pool unraveling. Priest’s unravelling story implies that consumers in Category 4 and Category 2, both groups being low-income consumers, would be the first to leave a pool because of a price increase. The withdrawal of Category 4 consumers would necessitate a price increase, but the withdrawal of Category 2 consumers would have no predictable effect on price. It is possible that relatively low-income consumers would, on average, have a high probability of being in an accident. To the extent that this is true, the withdrawal of low-income consumers will have no obvious effect on the product prices. At any rate, of the consumers remaining in any given risk pool as Category 4 and Category 2 consumers exit the pool, Category 3 consumers, who by hypothesis are not so sensitive to price increase, would subsidize Category 1 consumers. Thus, unravelling seems less plausible once the distinction is made between consumers who pose a high risk because their incomes are relatively high and

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136. It may be the case, in other words, that low-risk consumers tend to have the greatest probability of being in an accident. See Epstein, *Unintended Revolution*, supra note 1, at 2215-16 (making similar point with regard to worker injury cases). Low-income individuals may have less aversion to risk than high-income consumers do and, therefore, may be more willing to engage in risky activities. Cf. G. STIGLITZ, *MEMOIRS OF AN UNREGULATED ECONOMIST* 10 (1988) (suggesting that economically disadvantaged groups may tend to be less risk-averse); Keeton & Kwerel, *Externalities in Automobile Insurance and the Underinsured Driver Problem*, 27 J.L. & ECON. 149 (1984) (drivers may underinsure if they do not stand to lose more than the sum of their assets and their insurance coverage); Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053, 1058-59 (1977) (poor consumers may be somewhat more willing than middle-class consumer to bear more purchase risks in exchange for lower prices).
consumers who pose a high risk because for them the probability of having an accident is relatively high.\textsuperscript{137}

Another theoretical weakness of Priest's consumer risk pool unravelling theory is that it assumes "high-risk" consumers would be attracted to consumer risk pools in which they are cross-subsidized. At first blush, it might seem rational for high-risk consumers to join product risk pools in which they pose a greater-than-average risk.\textsuperscript{138} All else equal, it seems that everyone would prefer to be on the receiving end of a subsidy. But because nonpecuniary losses are, by definition, not fully compensable,\textsuperscript{139} high-risk consumers may not want to be cross-subsidized in a pool where nonpecuniary losses constitute a significant portion of the risk. Consumers are not indifferent between the state of the world in which they suffer a nonpecuniary loss and receive damages and a state of the world in which they suffer no nonpecuniary loss and receive no damages. Because damage awards will not fully compensate them, victims of a nonpecuniary loss will prefer the non-injury state of the world. This preference for avoiding injuries gives consumers an incentive to avoid consuming products for which they pose above-average risk. This is true because from these consumers' perspectives, manufacturers of such products will be investing insufficiently to prevent nonpecuniary losses.

A product manufacturer will not, even when liable for the injuries caused by its product, have an incentive to make its product as safe as the relatively high-risk consumers of that product would be willing to pay.\textsuperscript{140} To understand

\textsuperscript{137} This theoretical objection to Priest's unravelling theory might be clarified with an example. Imagine that the world contains two types of lawn-mowing individuals: careful mowers, who observe all safety instructions on their equipment and pay close attention to the rocks and bumps in their lawns, and careless mowers, who disregard all instructions and hurry the job heedless of safety. There are high-income and low-income mowers of both types, and thus four sets: careful, high-income mowers; careful, low-income mowers; careless, high-income mowers; and careless, low-income mowers.

As Priest's analysis suggests, high-income mowers pose a high risk to their lawn mower manufacturers because, if injured, they will tend to collect high damage awards; similarly, low-income mowers pose a low risk to their manufacturers because, if injured, they will tend to collect lower damage awards. But Priest's analysis does not capture the "if injured" dimension of risk; that is, the probability of a lawn-mowing accident occurring in the first place. Careless mowers—whether high-income or low-income—pose a higher risk to their manufacturers because the probability is relatively high that they will, for example, leave their lawn mower blades running as they stoop for a drink from the hose. In contrast, careful mowers—whether high- or low-income—pose a lower risk to manufacturers since the probability of a mowing accident is for them relatively small. Now, the effect of a given low-income consumer exiting an insurance pool depends on whether that low-income consumer was a careful mower or a careless mower. The exodus of low-income, extremely careless mowers may actually lower the average premium a manufacturer must charge. In any case, there is no reason to think that the exodus of low-income mowers would cause a pool to unravel, in absence of information about whether (and to what extent) those individuals were careful or careless.

\textsuperscript{138} Legal economists generally assume that this form of adverse selection is rational. See, e.g., Schwartz, Proposals, supra note 10, at 405-06.

\textsuperscript{139} Priest, Insurance Crisis, supra note 19, at 1559; see P. Dzon, supra note 22, at 10 ("Harder to measure but no less real are the pain and suffering and the diminution in the quality of life that result from physical impairment. These are irreplaceable losses that cannot be recompensed by monetary compensation."); Epstein, Insurance Market, supra note 1, at 653 ("Money is an unsatisfactory substitute for health or wholeness."); Priest, Modern Reform, supra note 17, at 8 ("[N]o personal injury can ever be fully compensated . . .").

\textsuperscript{140} See generally L. Bebchuk & S. Shavell, Information and the Scope of Liability for Breach of Contract (April 1989) (unpublished manuscript on file with authors); cf. Schwartz, Proposals, supra note 10, at 371 ("Firms commonly are responsive to the preferences of consumer groups, rather than the preferences of every consumer.").
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Why this is true, consider the argument made by Judge Posner in his analysis of the incentive effects of allowing a high-risk photographer to recover full damages for a manufacturer-caused loss: "The manufacturer of the film will probably take no additional precautions . . . because he cannot identify the films whose loss would be extremely costly, and [therefore] . . . it may not pay to take additional precautions on all the films . . . ."141 Even if manufacturers are strictly liable, they still will have inadequate incentives to invest in product safety up to the point where the cost of accidents is minimized for high-risk consumers. Consequently, high-risk consumers may not want to remain in a pool in which they are subsidized, even though they could receive money damages for their injuries. Instead, they would prefer to pay "extra" to join a pool consisting only of high-risk insureds, because only in such pools would manufacturers have the proper incentives to invest in preventing nonpecuniary losses.142

Another theoretical shortcoming of the unravelling theory is that it is not clear that low-risk consumers would be as willing to give up consuming a given product—thus causing the pool to unravel—as Priest suggests. To be sure, the better their available substitutes, the less tolerant low-risk insureds will be of cross-subsidizing high-risk insureds, and the more likely they would therefore be to choose alternatives. (Such a consumer might substitute either products that are less risky themselves or products for which the average risk of the pool is closer to the risk posed by that consumer.) In some product markets, however, substitutes may be scarce or non-existent. In those markets, low-risk consumers may be unwilling to exit the insurance pool because the cost of giving up the product would outweigh the benefit of avoiding an unfavorable insurance arrangement.


142. Alan Schwartz provides another possible reason why unravelling may not be so significant in the context of high nonpecuniary losses:

Nonpecuniary harms are not replaceable by insurance payments or damage judgments; rather, these transfers are used to purchase substitutes that make up for or assuage the pain of accidents. Because substitutes rather than replacements are at issue, the value people attach to the risk of incurring nonpecuniary harm is a function of people's income. This follows from the diminishing marginal utility of money theory, which holds that a poor person would miss the marginal dollars required to purchase substitutes more than a rich person, and so the former would pay more to avoid having to purchase substitutes—that is, pay more to reduce the risk of harm.

Schwartz, Proposals, supra note 10, at 408 (footnote omitted). Schwartz seems to suggest here that even if low-income individuals receive less compensation than high-income individuals for the same injury, the fact that both sets of consumers must pay the same premium for the insurance may not cause the pool to unravel, because low-risk insureds have a greater willingness to pay for that insurance than their high-risk counterparts do.
Finally, even if all the empirical assumptions that Priest makes were valid, and even if his unravelling analysis were theoretically sound, the unravelling theory would still contain an important weakness: Priest advocates greater reliance on first-party insurance as a solution to unravelling without showing that first-party insurance would be less susceptible to the unravelling problems than manufacturer-provided insurance has been. Priest’s conclusions depend on the propositions that consumer risk pools, especially those of products that have recently been withdrawn from the market, were broader than they would have been had manufacturer liability not expanded, and broader than the variance within first-party risk pools. But he offers no support for either proposition. It is quite possible that consumer risk pools may contain less cross-subsidization between low-risk and high-risk consumers than they did before the “crisis,” and less than first-party insurance pools contain.143

But even if consumer risk pools were found to be broad relative to first-party insurance pools, that would not imply that the former would be more likely to unravel than the latter. This is true simply because for a given level of variance, a pool’s tendency to unravel is greater the larger the benefits of exiting the pool are to low-risk members. If the size of the subsidy and the gains from avoiding it are relatively small, low-risk consumer-insureds may have less of an incentive to alter their consumption patterns to avoid subsidizing high-risk consumer-insureds in consumer risk pools than they do in first-party insurance pools.144 Put differently, the gains from adversely selecting to a high-risk consumer, and from unraveling to a low-risk consumer, might be relatively insignificant in consumer risk pools as compared to those in first-party insurance risk pools, because the absolute size of the cross-subsidy in most consumer risk pools is relatively small.145 Hence, to induce the same level of unravelling, all else equal, the variance would have to be greater in consumer-product pools than it would in first-party insurance pools.

Lastly, it is worth noting that the same cross-subsidization and unravelling problems that Priest believes plagued consumer risk pools under the current

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143. First-party insurance pools are far from perfect. See Hanson & Logue, supra note 73, at 141-53, 164-68; Akerlof, supra note 117, at 492-94 (health insurance suffers significant adverse selection problems); Feldman, Health Insurance in the United States: Is Market Failure Avoidable? 54 J. RISK & INS. 298 (1978) (group insurance produces non-trivial moral hazard and adverse selection problems).

144. Cf. Epstein, Insurance Market, supra note 1, at 668-69 (maintaining that insurance premiums in product prices are a “small fraction of the total cost of most goods”).

145. See infra text accompanying note 307. This proposition is related to the proposition that consumers invest in more “search” when shopping for expensive items than they do when shopping for inexpensive items. See G. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR 6-7 (1976); Westbrook & Fornell, Patterns of Information Source Usage Among Durable Goods Buyers, 16 J. MARKETING RES. 303 (1979); see also G. EADS & P. REUTER, DESIGNING SAFER PRODUCTS: CORPORATE RESPONSES TO PRODUCT LIABILITY LAW AND REGULATION 47 (Rand Institute for Civil Justice, 1983) (summarizing point); cf. J. COLEMAN, MARKETS, MORALS & THE LAW 217-39 (1988) (describing economic incentives of plaintiffs in class action settlements).
regime might also plague consumer risk pools under his proposed negligence regime. At its most fundamental level, Priest's unravelling theory turns on the size and variance of the damage awards granted, not on the liability rule employed. Yet Priest's proposed negligence regime, in which injured consumers would be compensated for negligently caused pecuniary and nonpecuniary losses, would have no predictable effect on the size of damage awards.

C. The Unravelling of Manufacturer Risk Pools

According to Priest, expanding liability has led to the unravelling of manufacturer risk pools because "[i]ndividual firm riskiness and the variance of individual riskiness among firms both increase as the scope of liability expands." As explained above, the unravelling of insurance pools is precipitated by an increase in the variance of risks posed by pool members. An increase in variance means that, all else equal, there is an increase in the cross-subsidization of high-risk pool members by low-risk pool members. As the cross-subsidies increase, so do the incentives for high-risk insureds to select adversely into risk pools and for low-risk insureds to exit risk pools. The question arises, then, of what causes the increased variance in manufacturer risk pools. The subsections that follow argue that Priest has not provided a satisfactory answer to that question.

1. The Uncertain Effects of an Increase in Individual Firm Riskiness

Priest's first explanation for the unravelling of manufacturer risk pools, just like his explanation for the unravelling of consumer risk pools, depends upon his claim that the variance within consumer risk pools has increased: "[T]he increase in corporate tort liability has increased the variance in risk pools comprising consumers of corporate products and services. This increased variance, of course, increases the individual riskiness of each corporate provider, requiring an increase in the corporate casualty premium." However, as shown above, Priest's claim that there has been an increase in the variance of risks presented to manufacturers by consumer groups is empirically unsubstantiated and theoretically implausible.148

But even if it were true that the variance within consumer risk pools significantly increased, it would not follow that manufacturer risk pools would unravel as a result. If, as Priest contends, consumer risk pools did unravel, then the variance of risks faced by manufacturers should have become narrower as a result. Indeed, if Priest is correct that the unravelling of

146. Priest, Insurance Crisis, supra note 19, at 1562.
147. Id. at 1561 (emphasis added).
148. See supra Parts II(B)(2)-(4).
consumer risk pools often continued until a product was completely withdrawn from the market, it must also be true that such unravelling often reduced the variance of manufacturer risk pools to a level lower than it was before the alleged expansion of manufacturer liability. In short, the unravelling of consumer risk pools should have led to a smaller variance within manufacturer risk pools and should thereby have eliminated the variance that Priest suggests plagued manufacturer risk pools.

Moreover, Priest does not explain how an increase in the riskiness of individual firms itself could have any negative effect on corporate liability insurance. Again, according to Priest's theory, risk pool unravelling is precipitated by an increase in the variance of risks posed by member insureds. Thus, an increase in the riskiness of individual manufacturers could have led to unravelling only if that increase caused an increase in the variance within manufacturer risk pools. But an increase in expected liability costs for a given manufacturer (say, from $20 before the expansion to $35 after the expansion) does not imply an increase in variance among manufacturers. In Figure 1, the variance within the manufacturer risk pool (a standard deviation of 15) was unaffected by the expansion. Priest acknowledges that an increase in variance, an increase in expected liability costs would not adversely affect manufacturer risk pools.49 Thus, when Priest refers to an increase in individual corporate riskiness, he is apparently not referring to an increase in the expected liability costs of corporations that may have resulted from the change in the liability rule.

To understand better what Priest does mean when he speaks of an increase in corporate riskiness, consider the probability distributions depicted in Figure 2. The expected liability is the same in both cases ($35), but because the spread of possible liability outcomes is greater after the alleged expansion of liability, the corporation is riskier. Before the expansion, the probability distribution has a standard deviation of 15; after the expansion, the standard deviation is 30. It is in this sense that Priest argues that individual corporate riskiness has increased.50

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49. Priest writes:

[Some] forms of expanding liability . . . will not affect insurance markets. . . . [including] increases in the level of damage judgments . . . Other things equal, a scalar (proportionately equal) increase in the level of tort judgments and settlements will not affect the degree of insurability of any risk. A scalar increase in tort payouts, other things equal, will not change the ratio of the premium to an insured’s expected loss. The premium set equal to the average risk brought to the pool will increase by exactly the same proportion as will the expected loss to the insured.

Priest, Insurance Crisis, supra note 19, at 1551.

50. That increase in variance matters only if corporations are risk averse, as Priest implicitly assumes they are. Otherwise, it is not clear that they would mind this risk. See Epstein, Insurance Market, supra note 1, at 649 (adopting view similar to Priest’s); Gary Schwartz, Directions in Contemporary Products Liability Scholarship, 14 J. LEGAL STUD. 763, 775 (1985).
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Figure 1

Effects of Increase in Individual Firm Riskiness

Before the Expansion

Probability

Expected Liability Costs

After the Expansion

Probability

Expected Liability Costs
Figure 2

Effects of Increase in Individual Firm Riskiness

Before the Expansion

Expected Liability Costs

After the Expansion

Expected Liability Costs
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But there is little reason to think that insurers would raise premiums in response to this form of risk. An increase in the variance of expected liability costs among members of a pool of uncorrelated insureds need not create any significant increase in the variance of the pool itself. Indeed, elsewhere in his argument Priest emphasizes that “risk spreading” or the “reduction in the coefficient of variation of the probability function of average loss,” is “achieved by the aggregation of independent risks.”151 This aggregation “lowers the effective risk to each member of the pool.”152 He emphasizes further that “risks can be spread efficiently over very small numbers of the population.”153 Because Priest has not shown why an increase in the variance of individual firm riskiness would lead to an increase in the variance of the pool itself, he has not shown why an increase in individual firm riskiness would cause commercial casualty premiums to rise.154

2. Variance of Riskiness Among Firms

Priest’s second explanation for the breakdown of manufacturer risk pools is the increase in “the variance of individual riskiness among firms in insurance pools.” He writes:

The increase in corporate riskiness affects the commercial casualty insurance market in an additional way. The effect of the expansion of corporate liability varies for different companies, depending upon the risk characteristics both of a company’s product or service and of its consumers. The shift to greater third-party tort insurance coverage increases these differences among firms.155

151. Priest, Insurance Crisis, supra note 19, at 1543.
152. Id.
153. Id.; see Priest, Modern Reform, supra note 17, at 15 (“[E]ffective risk spreading can occur with very low numbers of risks aggregated into a single pool, as long as the risk of injury of each member of the pool is uncorrelated. Thus, it is not necessary to aggregate pools of the dimension of the total set of product consumers to achieve optimal spreading.”); see also S. Ross & R. Westerfield, Corporate Finance 152 (1988) (“In general, if assets are not perfectly positively correlated, diversification can reduce portfolio variability.”).
154. While Priest argues that the increased correlation of corporate risks can explain the increase in corporate insurance premiums, the problem is that he offers increased firm riskiness and increased risk correlation as two independent reasons for premium increases. If by the former explanation he means only to be giving the latter explanation, then the two converge into one. In any event, neither of these explanations locates the source of increased variance necessary for manufacturer risk pools to unravel.
155. Priest, Insurance Crisis, supra note 19, at 1562.
This description of corporate riskiness raises several important questions. For example, why has the expansion increased manufacturer risk pool variance? Priest asserts that the expansion of tort liability has affected different firms differently, causing some firms' risk of liability to increase enormously and other firms' risk to increase to a smaller extent. He then suggests that the variance within manufacturer risk pools—that is, the disparity between the high-risk member firms and low-risk member firms—has therefore increased, leading to adverse selection and ultimately to unravelling. However, he provides no evidence for this empirical claim. And without an injection of variance into manufacturer risk pools, it is not clear how these risk pools could have unravelled.

But assuming for the sake of argument that the expansion of tort liability has caused an increase in the variance within manufacturer risk pools, it is not at all clear how such an increase could have led to adverse selection by manufacturers. An increase in the variance of expected risks among firms is necessary, though not sufficient, to generate unravelling in manufacturer risk pools. For adverse selection to occur, (1) low-risk firms must recognize that they have relatively low expected liability costs; and (2) third-party insurers must be unable to distinguish the high-risk from the low-risk members of the pool. Priest, apparently aware of these other necessary conditions (in addition to an increase in variance), completes his unravelling argument as follows:

If commercial casualty insurers are able to predict how firms differ in riskiness, then they can tailor an insurance premium appropriately for the risk that underwriting the particular corporation adds to the insurer's portfolio. The sale and purchase of commercial casualty insurance, however, requires a convergence of risk estimates by the insurer and the corporation. When the insurer believes that the risk level of a firm is greater than the firm believes it to be, the firm is likely to find self-insurance more attractive than market insurance.

156. Id. Whether increased variance within manufacturer risk pools would actually lead to adverse selection is discussed immediately below.
157. Priest recognizes that insureds must be asymmetrically informed for adverse selection to occur: "[I]f firms have better knowledge of their underlying level of riskiness than insurers, these differences in expectations will lead relatively low-risk firms to drop out of the insurance pool and relatively high-risk firms to stay in the insurance pool. This is adverse selection in the commercial casualty market." Priest, Insurance Crisis, supra note 19, at 1562.
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The shift to corporate tort liability increases the extent of adverse selection. . . . [The] increases in the range of potential liability outcomes across firms increase the likelihood of differences in insurers and corporate estimates of underlying corporate riskiness. As a consequence, adverse selection is likely to increase. Low-risk firms are increasingly likely to withdraw from the commercial casualty market leading to an increase in the premiums and an increase in the likelihood that the commercial casualty pool will unravel.\textsuperscript{158}

Assuming there were rapid changes in the law, it may have been the case that neither insurers nor manufacturers knew which manufacturers were low-risk members of the insurance pool. Priest seems to take this view when he argues that “increases in the range of potential liability outcomes across firms” have led to an increase in “the likelihood of differences in insurer and corporate estimates of underlying corporate riskiness.”\textsuperscript{159} However, that argument does not suggest that the increased variance among firms causes the sort of asymmetry of information necessary to spawn adverse selection. Rather, that argument suggests that both groups—manufacturers and insurers—are uninformed in their attempts to estimate “corporate riskiness.” And, due to the wider range of potential risks facing each manufacturer, there is an increased chance that insurers and manufacturers will fail to agree on a premium that is acceptable to both. According to this view, insureds who exit the pool are those who believe themselves to be less risky than insurers believe them to be, not those who are, \textit{in fact}, less risky than their premiums suggest. Ultimately, Priest provides no support for the claim that insurers are asymmetrically uninformed. He does not explain what information insureds possessed that insurers did not

\textsuperscript{158}. Priest, \textit{Insurance Crisis, supra} note 19, at 1562.
\textsuperscript{159}. \textit{Id.}
also possess. Absent such an explanation, it simply does not follow that greater uncertainty increases adverse selection and unravelling.

160. It would seem that information regarding the relative riskiness of manufacturers is at least as easily available to insurers as it is to individual manufacturers. Arguably, either (1) insurers have better information than manufacturers do about manufacturers’ changing risk of tort liability, or (2) both insurers and manufacturers are uninformed about manufacturers’ changing risk of liability, such that there is not the sort of asymmetrical information that can lead to adverse selection and unravelling.

Broadly speaking, there are two types of information necessary for an insurer to determine a manufacturer’s risk of liability: (1) information regarding the expected costs of injuries caused by the manufacturer’s products; (2) information regarding the likelihood that courts will hold the manufacturer liable for those accidents. For simplicity, these two types of information shall be referred to as “risk information” and “liability information,” respectively.

What has changed recently in commercial casualty insurance markets is not that insurers suddenly know less about their insureds. According to Priest’s description, there was no decline prior to the “crisis” in the amount of information insurers had about their insureds. Following the expansion of liability, however, insurers might have needed to know additional risk information about their manufacturer-insureds. For instance, since the new regime awards nonpecuniary-loss damages, insurers have had to gather information on the size and frequency of nonpecuniary losses caused by manufacturers’ products. Without that information, insurers would have been unable to segregate their insureds according to risk. Even if this is true, however, it does not support Priest’s proposal for drastic reform of products liability, because the insurers’ information deficit would last only as long as it took insurers to gather the new information. Moreover, even if insurers had little information about newly relevant characteristics of their insureds, it would seem that insureds themselves would have been equally ignorant about characteristics that had previously been irrelevant to the insureds’ prospects for liability. Showing that insurers were uninformed about newly relevant risk information does not support Priest’s unravelling story unless it can also be shown that insurers were uninformed asymmetrically.

A second possibility for the unravelling of manufacturer risk pools might be that insurers, because of the changes that had already occurred, were considerably less certain about how the law might change in the future regarding the injuries caused by its insureds’ products. Insurers, in other words, might have had the same amount of risk information but less liability information. But liability information also does not seem to be the sort of information that would be asymmetrically distributed to insurers. Indeed, it seems reasonable to assume that insurers would have better information than insureds regarding the current legal regime as well as its likely direction. Third-party insurance carriers have legal staffs devoted to processing tort claims, and would seem to have a comparative advantage over the typical manufacturer-insured at understanding changes in tort law and estimating the effect of these changes. Moreover, insurers have a much larger incentive to become informed of changes in the law than individual insureds do. That is true because insureds, once they obtain insurance, are relatively indifferent to changes in the law. The benefits of knowing the law and anticipating changes in the law are much higher to insurers, who are responsible for entire pools of insureds, than to any one of their individual insureds. As one commentator observed prior to the expansion, “In some instances, the manufacturers apparently do not even inform themselves of the final resolution of these claims, and for these manufacturers it is obvious that a court decision will have no direct effect on product design or warning decisions.” Whitford, Law and the Consumer Transaction: A Case Study of the Automobile Warranty, 1968 Wis. L. Rev. 1006.

But even if manufacturers had some information that their insurers did not, it is not clear that that would have led to adverse selection. Low-risk insureds would have a strong incentive to disclose that information to insurers to prove that they were in fact low-risk insureds. Their alternative would be to withhold information and pay the pool rate. Hence, insurance pricing may act as a “penalty default,” through which information is passed to insurers, because good risks disclose while bad risks do not, and insurers can thereby measure or infer each insured’s relative riskiness. See Ayres & Gertner, supra note 141, at 93-107. Accordingly, insurers will offer such manufacturers a lower premium. Adverse selection and unravelling in manufacturer risk pools, at least of the magnitude that Priest describes, seems unlikely.

161. Priest’s analysis of whether firms and liability insurers will strike a bargain is much like the standard economic analysis of whether potential litigants will reach a settlement rather than go to trial. The bargain, in either case, depends in large part on each party’s estimate of the size and the probability of loss and on the costs of not reaching a bargain. See R. COOTER & T. ULEN, supra note 1, at 494-97; R. POSNER, ECONOMIC ANALYSIS, supra note 67, at 522-328; Shavell, Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs, 11 J. LEGAL STUD. 55 (1982). Priest’s analysis is interesting inasmuch as it suggests that there may be fewer insurance contracts because of divergent estimates of corporate risk. But the analysis does not support his conclusion, because it does not explain why there would be unravelling of low-risk insureds.
What Liability Crisis?

3. Systematic Misestimations of Manufacturer Risk

Priest’s theory of the unravelling of manufacturer risk pools is still more problematic because it requires the implausible empirical assumption that third-party liability insurers systematically underestimated the riskiness of high-risk manufacturer-insureds. This empirical assumption is a necessary implicit premise of the argument given Priest’s description of how liability insurers determine what premiums to charge their insureds. He writes:

Much of the insurance coverage implicated in the recent crisis consists of what is called special risk underwriting: the provision of insurance in a highly individualized manner to insured firms, with premiums set according to the particular characteristics of the insured firm itself.162

Much of the insurance business involves literally individual assessment and pricing of risks. . . . “Special risk underwriting” . . .—which is more predominant in some of the commercial casualty lines affected by the insurance crisis—involves risk estimates by the insurer on an individual risk-by-risk basis, with the premium (rather than a rate) set with the particular characteristics of the insured in mind.163

Here Priest makes clear that products liability insurance premiums are based upon an insurer’s assessments of the risk posed by individual insureds. If liability insurers engage in “special risk underwriting,” then an insurer’s “pool” is simply the set of its insureds, who do not necessarily share anything in common with one another other than a common insurer.

This conception of an insurance “pool” is different from the classic conception of an insurance pool as a collection of insureds about whom an insurer does not have individualized information and therefore charges every pool member the same premium, a premium which reflects the average expected damages of all pool members. Employment-based group health insurance is a paradigmatic example of this type of insurance pool. Members of these pools not only share a common insurer but also pay the same premium. Consumers of a given product, about whom the product’s manufacturer does not have individualized information, also constitute such a pool, and Priest seems to invoke this conception of an insurance pool in his discussion of consumer risk pool unravelling. The problems of adverse selection and risk pool unravelling stem from the fact that in the classic insurance pool the premium charged to every member of the pool reflects the average risk of all members of the pool.

162. Priest, Antitrust Suits, supra note 47, at 1006.
163. Priest, Insurance Crisis, supra note 19, at 1544; see also Abraham, Environmental Liability, supra note 32, at 954 (describing “risk assessment” and “risk management” in “pollution liability insurance field”).
As Priest explains, however, liability insurers are charging manufacturers' premiums based not on averages but on the particular characteristics of the insured firm. Under these circumstances, adverse selection would occur only if the insurer systematically undercharged high-risk insureds. And low-risk insureds would exit the pool only if they were systematically overcharged.

Yet there is no reason to believe that insurers would systematically overestimate the risks posed by their low-risk insureds or systematically underestimate the risks posed by their high-risk insureds. One would expect insurers engaged in "special risk underwriting" to estimate their insureds' risks correctly on average. That is, insurers might over- or under-estimate the risks posed by both high-risk and low-risk insureds, but presumably the insurers' estimates would be distributed normally around the correct value of insureds' risks.

But even if insurers systematically undercharged high-risk insureds and overcharged low-risk insureds, that would not support Priest's unravelling story. Once it is recognized that each insurer sets premiums for insureds on the basis of the insurer's estimate of the risks that each insured poses, it becomes difficult to imagine how risk pool unravelling would proceed. If an insurer were to overestimate the risk posed by its low-risk insureds, those low-risk insureds might exit the insurer's pool. But this would not cause other insureds' premiums to rise since, by hypothesis, the insurer is setting premiums based on individualized assessments of each insured and not according to the average risk posed by all insureds in a given risk pool.

4. Accounting for the Increase in Liability Premiums

Priest criticizes other explanations of the crisis for failing to account fully for the increase in liability premiums. For instance, he writes:

The Justice Department's study . . . does report case-law trends in fields subjected to substantial premium increases or withdrawals of insurance coverage. Yet the Justice Department's study falls far short of documenting the source of the current crisis. The increase in rates of claims and size of damage awards reported by the Justice Department are far smaller than reported increases in insurance premiums. . . . No trial or settlement statistics . . . have shown increases that even remotely correspond to the increases in insurance premiums at multiples of four, five, ten, fifteen, and more over a period of a few months.\[164\]

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\[164\] Priest, Insurance Crisis, supra note 19, at 1533-34; see also Priest, Understanding the Crisis, supra note 47, at 198 ("The rise in [liability] insurance costs, especially when policy terms are taken into account, clearly outpaced recent claims and judgments, just as it far outpaced interest-rate changes.")
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These unusual premium increases . . . are the most damaging evidence to the Justice Department’s effort to link the crisis to tort law, since there is no conceivable correspondence between changes in past tort judgments (and little correspondence to plausible future judgments) and premium increases of four, ten, twenty, and more.\(^\text{165}\)

According to Priest, the most plausible explanation for these increases in liability insurance premiums is as follows:

The extraordinary increases in premiums within an exceptionally short period are the best evidence of the effect of expanding tort law on the constitution of commercial casualty insurance pools. The most plausible explanation for these unusual increases is the rapid departure of low-risk members from commercial casualty pools. As the low-risk members drop out, the unraveling process begins. Premiums skyrocket.\(^\text{166}\)

For Priest, the data on premium increases constitute a significant anomaly for other theories but provides “the best evidence” for his unravelling story. However, evidence of increase in overall tort judgments is only relevant to the average increase in insurance premiums.\(^\text{167}\) That there was an aggregate increase of a moderate amount across all pools says nothing about how substantial the increases in the pools most seriously affected were. Priest’s argument would be more plausible if the increases in the average size and number of tort judgments affected all insurance pools equally.

But surely the increase in the average size and number of tort judgments affected different insurance pools differently. Indeed, it is Priest who argues that the effect of this liability expansion “varies for different companies, depending on the risk characteristics both of a company’s product . . . and of its consumers.”\(^\text{168}\) Moreover, the fact that premiums increased by varying amounts, by multiples of “four, ten, twenty, and more,” shows that the increases in the average number and size of tort judgments affected different pools differently. Similarly, the fact that the “crisis has occurred only in selected commercial casualty lines,” as Priest emphasizes, suggests that what was true on average was not necessarily true for each insured. And finally, the fact that “[m]uch of the insurance coverage implicated . . . in the recent crisis consists of . . . special risk underwriting: the provision of insurance in a highly individualized manner to insured firms, with premiums set according

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\(^{165}\) Priest, Insurance Crisis, supra note 19, at 1577-78.
\(^{166}\) Id. at 1578; see also Priest, Tort Law, supra note 47, at 537 (making similar argument); Priest, Antitrust Suits, supra note 47, at 1014 n.45 (summarizing argument).
\(^{168}\) Priest, Insurance Crisis, supra note 19, at 1562.
to the particular characteristics of the insured firm itself" further suggests that an increase in expected liability costs across all insureds would have varying implications for the premiums of each individual insured. In short, it is no surprise that Priest could find some insurance premiums which had increased by more, even substantially more, than the average increase in federal tort judgments.

D. Summary of Part II

Part II challenged the plausibility of Priest’s primary contribution to the products liability reform movement: the theory of unravelling risk pools. This Part challenged the empirical and theoretical bases for both tiers of the unravelling theory. With respect to the consumer risk pool tier, Part II questioned the plausibility of the following empirical assumptions: consumers are asymmetrically informed vis-à-vis manufacturers about the risks they pose relative to other consumers; consumers’ income levels correlate with the amount of pecuniary damages they can expect to receive through products liability damages; consumers’ income levels correlate with the amount of nonpecuniary damages they can expect to receive through products liability damages; and manufacturers are unable to segregate consumers according to the risks they present. Part II has also argued that even if those assumptions held, the risk posed by a particular consumer is a function not only of the consumer’s income but also of a product injury, and, therefore, that the exodus of low-income consumers from consumer risk pools would not necessarily spawn unravelling. Moreover, it is unclear as a theoretical matter whether high-risk consumers would prefer to join product risk pools in which they enjoyed an insurance subsidy rather than join pools in which there is no cross-subsidy but in which the products’ manufacturers make greater investments in safety. Similarly, it is not clear that low-risk consumers would give up products merely because those consumers are on the wrong end of an insurance subsidy. Finally, even if unravelling were a problem in consumer risk pools, it is not clear that it would not be just as much or more of a problem in first-party insurance pools.

With respect to manufacturer risk pools, Part II pointed out that to the extent that consumer risk pools really have unravelled, the variance within manufacturer risk pools should have decreased, not increased. This Part also questioned how the expansion of manufacturer liability could possibly have increased the variance within manufacturer risk pools, and, moreover, how an increase in variance would have led to adverse selection by manufacturer-insureds in light of the fact that there is little reason to believe that commercial liability insurers were asymmetrically uninformed. Part II also pointed out that in light of the fact that the commercial insurance pools that Priest claims “unravelled” were “pools” where the premiums had been set through “special
risk underwriting" (that is, on an "individual risk-by-risk basis"), even the theoretical possibility of adverse selection or unravelling is eliminated. Finally, this Part argued that the phenomena that Priest views as "the best evidence" for his unravelling theory—the extraordinary increases in certain liability insurance premiums—are not inconsistent with the more moderate increase in the number of claims and size of damage awards, and hardly constitutes persuasive evidence of unravelling.

Part III below takes up a more constructive project, providing a set of arguments that constitute an alternative explanation for recent events in products liability.

III. An Alternative Explanation For The Liability "Crisis"

A. Introduction to Part III: The Crisis Phenomena

This Part argues that there has been no crisis in products liability. The recent phenomena associated with the "liability crisis" can be attributed not to the unravelling of insurance pools but rather to two efficiency-enhancing developments—the internalization of the nonpecuniary costs of product accidents and the internalization of the first-party insurance externality—as well as to an increase in socio-legal uncertainty.

Section B argues that the inclusion of nonpecuniary losses in damage awards has caused consumers (and therefore manufacturers) to internalize the full costs of accidents resulting from product use. Section B also explains the insurance and deterrence effects of including nonpecuniary losses in damage awards. From an insurance standpoint, the inclusion of nonpecuniary losses is desirable because it provides consumers with insurance that they desire but generally cannot buy. From a deterrence standpoint, the inclusion of nonpecuniary losses is desirable because it optimizes both care levels and activity levels. Section C explains the first-party insurance externality. Finally, Section D presents and explains the effects of socio-legal uncertainty on the insurance market and argues that the recent shift to mutual forms of organization is the market's efficient response to socio-legal uncertainty. Later, Part IV will compare the alternative explanation provided in this Part with Priest's unravelling theory.

But before providing an alternative explanation, it is necessary first to specify clearly the empirical phenomena that require explanation. For fairness and simplicity, this Article takes the following eight empirical phenomena as those that require explanation:

169. Although Priest does not provide such a list, it is possible to locate at various points in his scholarship the eight phenomena listed above for which a complete theory of the liability crisis must account. See Priest, Insurance Crisis, supra note 19, at 1527 (listing the phenomena for which a theory of the crisis must account); id. at 1563-64 (same); Priest, Understanding the Crisis, supra note 47, at 197.
1. The increase in the number and size of tort awards;
2. The still greater increase in the size of liability insurance premiums;\footnote{170}
3. The restructuring of liability insurance contracts (reduction of coverage);\footnote{171}
4. The withdrawal of some lines of liability insurance;
5. The trend toward self-insurance (or industry-wide mutuals);
6. The fact that the above phenomena did not also occur in first-party insurance markets (for example, life, health, and disability insurance);\footnote{172}
7. The decrease in the rate of accidents over time;\footnote{173}
8. The withdrawal (or curtailment) of certain consumer products from the market.

This Part offers an alternative explanation for these eight phenomena, an explanation that suggests there was no crisis at all.

Again, according to this alternative explanation, three factors can account for all of the phenomena associated with the “crisis”: (1) the internalization of nonpecuniary losses; (2) the internalization of the first-party insurance externality; and (3) the increase in socio-legal uncertainty. Each factor can be taken as independent of the others, and each factor can explain a substantial portion, if not all, of the eight “crisis” phenomena.

B. Internalizing the Nonpecuniary Costs of Product Accidents

As mentioned above, courts expanded manufacturer liability not only by holding manufacturers liable for product accidents more often, but also by holding them liable for greater amounts. During the most recent stage in the evolution of products liability, courts have more often awarded injured con-

\footnote{170} See supra notes 164-66 and accompanying text.
\footnote{171} See also Torts Policy Working Group, 1987 Update, supra note 1, at 21-22 (describing the reduction in coverage).
\footnote{172} Priest, \textit{Insurance Crisis}, supra note 19, at 1582 ("There are vast lines of insurance that have been totally untouched by the crisis. All first-party insurance lines—auto, health, life, disability—have been largely unaffected. Even some third-party lines, such as auto and workers' compensation have been unaffected.").
\footnote{173} Priest, \textit{Understanding the Crisis}, supra note 47, at 198-203; Priest, \textit{Risk Control}, supra note 47, at 222 (The "data show uniformly, within each field, that accident rates have been declining steadily over exactly the same period during which claims and claims dollars have been increasingly sharply."). Priest's evidence that the accident rate has decreased seems inconclusive. Priest acknowledges that there are some problems with the data but maintains that the data are nevertheless suggestive. Priest, \textit{Understanding the Crisis}, supra note 47, at 200; see also Priest, \textit{Accident Rate}, supra note 47, at 195 ("The quality of empirical data is so poor . . . that no confident conclusion can be reached about the success of products liability in establishing incentives for the manufacture of safer products.").}
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...sumers damages for the nonpecuniary elements of their losses. This Section will consider the effects of nonpecuniary loss awards. Because courts could have awarded damages for the nonpecuniary costs of accidents whether or not the liability rule became more expansive (that is, whether or not it moved from negligence toward strict enterprise liability), this Section will consider the consequences of awarding damages for nonpecuniary losses in both a pure negligence regime and a more expanded liability regime.

1. Compensation for Nonpecuniary Losses in a Pure Negligence Regime

It has already been noted that even the negligence regime that Priest proposes might have led to the insurance "crisis." Priest and others point to the increase in the number of tort claims and to the increase in the size of tort awards as evidence that there has been an expansion in liability standards. The probability of winning an award both have increased for plaintiffs. To be sure, an expansion in the liability standard may help explain these empirical phenomena (and this possibility is examined below), but the increase in the number of claims and the size of awards may also be explained, in part or in full, by the fact that courts now include nonpecuniary losses in their negligence determinations and in damage awards, as deterrence objectives require. For the same

174. See Priest, Insurance Crisis, supra note 19, at 1536 & n.89. Here and throughout, a "nonpecuniary loss" is taken to be a loss of the value of something that the injured party considered irreplaceable, minus its market value. For example, the loss of a family heirloom of little market value would constitute a nonpecuniary loss. A fortiori, the loss of a valued object for which there was no market at all, such as a limb, would also constitute a nonpecuniary loss. So too would intangibles such as happiness, for which there is no market. Damage awards for "pain and suffering," "emotional losses," "loss of consortium," and so on, are subcategories of nonpecuniary losses, just as damages for lost earnings and medical expenses are subcategories of pecuniary losses. While many if not most losses have pecuniary and nonpecuniary elements to them, "pecuniary losses" and "nonpecuniary losses" are taken to be exclusive and exhaustive categories.

175. See supra notes 84-87 and accompanying text, and Part II(B)(4).

176. See Product Liability Reform Act, S. Rep. No. 422, 99th Cong., 2d Sess. 6 (1986) ("The number of product liability cases filed in federal district courts has increased from 1,579 in 1974 to 13,554 in 1985, a 758% increase."); see also Litan & Winston, Foreword, in LIABILITY: PERSPECTIVES AND POLICY, supra note 26, at vii (citing the increase in number of personal injury lawsuits and size of awards as evidence of tort and insurance crisis); TORT POLICY WORKING GROUP, 1987 UPDATE, supra note 1, ch.3 (same).

177. Peterson & Priest, supra note 47, at 365; M. Peterson, CIVIL JURIES IN THE 1980s: TRENDS IN JURY TRIALS AND VERDICTS IN CALIFORNIA AND COOK COUNTY, ILLINOIS 17 (Rand Institute for Civil Justice, 1987) (plaintiffs have roughly doubled the percentage of tried cases in which they prevail before juries from around one-quarter in 1960-64 to one-half in 1980-84).

178. In San Francisco, for example, the average jury malpractice award adjusted for inflation increased by 830% from the early 1960s to early 1980s. Over the same period, awards increased by 1016% for products liability jury awards. M. Peterson, supra note 177, at 22.

179. See infra Part III(B)(2)-III(D).

180. Cf. TORT POLICY WORKING GROUP, 1987 UPDATE, supra note 1, at 38 ("Since non-economic damages are far more subjective and open-ended than economic damages, it should by no means be surprising that a sudden surge in damage awards would be largely attributable to a change in the non-economic component of such damage awards.").

181. Litan, Swire & Winston, supra note 15, at 7-13 (explaining that nonpecuniary component of jury verdicts appears to account for much of the increase in personal injury awards in products liability cases); Session Two, Discussion of Paper by Peter Huber, 10 CARDOZO L. REV. 2287, 2298 (1988) (remarks by P. Danzon) ("The size of awards has been increasing more rapidly than the frequency of claims. Aggregate damage awards are increasing at twice the Consumer Price Index each year. . . . [T]he damage awards may be one of the engines driving this increase in liability because they strengthen the incentive to pursue
accident, injured plaintiffs are, for two reasons, now more likely to bring claims. First, because courts now include nonpecuniary losses in their negligence determinations, manufacturers are more likely to be found negligent. Second, because the damages for preventable accidents now include nonpecuniary losses, courts are awarding higher damages. For both reasons, plaintiffs' expected tort awards for a given accident have increased. Thus, the "crisis" could have occurred even in a pure negligence regime.

To see this more clearly, consider Figure 3. From left to right, the horizontal axis represents a continuum of liability from "no liability" to "enterprise liability." From bottom to top, the vertical axis represents a continuum of damages from no damages to pecuniary damages alone to pecuniary and nonpecuniary damages.

Figure 3

Manufacturer Liability for Product Caused Injuries

<table>
<thead>
<tr>
<th>Nonpecuniary and Pecuniary Damages</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pecuniary Damages Only</td>
<td>D</td>
<td>E</td>
<td>F</td>
</tr>
<tr>
<td>0% Negligence w/o Nonpec.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negligence w/ Nonpec.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprise Liability 100%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

182. See supra Part I(B)(2).
Assume that courts have always applied a negligence standard in products liability cases but, until recently, included only pecuniary damages and disregarded nonpecuniary losses in both their negligence determinations and their damage awards (i.e., Approach 4, Table 1, *supra* Part I(B)(2)). Under this assumption, manufacturer liability for product-caused injuries would be limited to Box D. Now assume that courts began to include nonpecuniary losses in their negligence determinations and in their damage awards (i.e., courts shifted from Approach 4 to Approach 1, Table 1, *supra* Part I(B)(2)). Manufacturer liability would now include product-caused injuries in Boxes A, B, D, and E.\(^\text{183}\) The effect of including nonpecuniary losses (that is, of shifting from Approach 4 to Approach 1) would be indistinguishable from the effect of the alleged expansion of liability beyond negligence toward enterprise liability. In either case, damage awards would increase and manufacturers would be liable for accidents that they were not liable for prior to the change.

This argument can explain the increase in liability insurance premiums. Because liability insurers now must pay more for product-caused accidents (in terms of an increase in both the rate and the severity of claims), they have raised premiums for their insureds. That is, as depicted in Figure 3, liability insurers must increase premiums to cover, in addition to Box D, Boxes A, B, and E.

This greater liability can also explain why commercial liability insurers reduced the scope of their coverage (for example, by increased policy exclusions). Manufacturers that are covered by liability insurers for the costs of accidents are likely to disregard the costs of any accidents whenever they do not internalize those costs. As courts' treatment of nonpecuniary losses changed, manufacturers began to be held liable for nonpecuniary losses. Consequently, insurers were required pursuant to their newly outdated contracts to reimburse manufacturers for the manufacturers' liability for increasing amounts.

Inasmuch as this new moral hazard problem plagued liability insurance markets, liability insurers responded rationally by increasing copayment arrangements and excluding coverage for preventable accidents.\(^\text{184}\) Where it was impossible for liability insurers to adjust policies and premiums so as to overcome (or sufficiently mitigate) the moral hazard problem, the increase in the contract premiums could have been large enough to force some lines of insurance off the market.\(^\text{185}\) In turn, manufacturers might have chosen to self-
insure (or to find some other form of insurance that could better cope with this heightened moral hazard problem) and/or to withdraw some of their products from the market. These effects would be similar in kind if not also in degree to the empirical phenomena that Priest and others take as evidence of a liability crisis. Yet, these changes are not to be lamented. They represent the unavoidable consequences of socially efficient policies—that is, requiring manufacturers to internalize the full costs of accidents that they negligently cause.\(^6\)

This discussion helps to bring into focus a number of difficulties with Priest’s argument. Priest characterized changes in the liability insurance market as an inefficient “crisis.” He located the source of the “crisis” in the recent “expansions” of products liability doctrine. And he suggested that courts solve the crisis by adopting a negligence regime that compensates consumers for all losses including nonpecuniary losses. But it is not clear that Priest’s proposed regime is significantly different from the current regime, the putative source of the crisis. If his proposed regime would be efficient, then so might be the recent “breakdowns” in liability insurance markets.

Of course, Priest’s analysis is based on the empirical assumption that the liability standard, holding courts’ treatment of nonpecuniary-losses constant, has expanded to become significantly more strict than negligence. In terms of Figure 3, Priest’s view is equivalent to the view that manufacturer liability has expanded to include some significant portion of Boxes C and F. This expansion toward enterprise liability is, according to Priest, the real source of the crisis. Under the more strict standard, manufacturers are sometimes liable for accidents that they could not have prevented through additional investments in care. Indeed, Priest seems to assume that under the more strict standard manufacturers are liable mostly for accidents that they could not have prevented—that is, when they were not negligent.\(^7\) Put differently, Priest assumes that many of the cases brought under our current regime would not be brought under an ideal negligence regime. Based on this assumption, Priest concludes that nonpecuniary-loss damage awards have provided no deterrence benefits but have generated only deleterious insurance effects.\(^8\)

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\(^{186}\) Over time, allowing the amount of manufacturer care to vary, we might expect the number of claims to decline, because manufacturers would find it worthwhile to raise their level of care to meet the new standard. It is not clear, however, how much time is enough time. Cf. P. Danzon, supra note 22, at 66-67 (change in liability will affect number of claims depending on how long until insurers and then manufacturers react).

\(^{187}\) See supra notes 84-87 and accompanying text.

\(^{188}\) See supra note 85 and accompanying text.
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Figure 4
Continuum of Product-Caused Injuries

| A | B | C |

But that assumption asks a lot, as Figures 4 and 5 attempt to make clear. Assume that all product-caused injuries are lined up along the continuum in Figure 4. Segment A represents the injuries that manufacturers would be liable or under Priest's proposed negligence regime. Taken together, Segments A and B represent the product-caused injuries that manufacturers have been liable for under our strict liability regime. And the injuries along Segments A, B, and C (i.e., 100% of product-caused injuries) are those that manufacturers would be liable for under an enterprise liability regime. The relative size of these three segments is unknown.

Although Priest never employs such a diagram, his view of the empirical setting that gave rise to the crisis phenomena can be understood as depicted in Figure 5. Again, Segments A and B represent the injuries that manufacturers have been liable for under our strict liability regime. In Priest's view, the expansion toward enterprise liability has been almost complete such that Segment C is quite small. That is, Priest believes that courts have expanded strict liability almost to the point of enterprise liability. This view is not only rejected by several tort scholars who argue that our regime is effectively a negligence regime, it may also be contrary to recent evidence.

189. See, e.g., Priest, Enterprise Liability, supra note 1, at 527 ("the distance between prevailing standards and a standard of absolute liability progressively narrows").

190. See supra notes 16 & 84 and accompanying text.

191. What is perhaps the best available evidence suggests that, in fact, the liability standard was contracting, not expanding, during the insurance "crisis." See generally Henderson & Eisenberg, supra note 41. But, for several reasons, this evidence is not dispositive. First, it is difficult to ignore the fact that many keen observers of our products liability system, Priest included, share the belief that courts have been expanding liability over the relevant time period. Second, there may be lags between the time when a liability rule is changed, and the time that plaintiffs take account of that change in their decisions about whether to litigate, and the time that liability insurers adjust to the changes in their insurance premiums. If there are such lags, previous expansions in the law may have continued to influence liability insurance premiums at a time when the liability standard was actually contracting. Third, the increase in the rate of claims that results from the inclusion of nonpecuniary losses should be only a short-run phenomenon. Assuming the long run is no more than a couple of years, the number of claims should have tapered off to previous levels as manufacturers have had a chance to adjust their care levels to the new standard. But the rate of claims has not decreased to the previous level, though it has decreased somewhat, see Sanders & Joyce, supra note 41, at 227-28, suggesting that the standard itself did in fact expand such that manufacturers are now liable for a greater number of unpreventable accidents.
Although it is unclear what percentage of product-caused injuries manufacturers would be liable for under an ideal negligence rule, there is evidence to suggest that the liability standard giving rise to the “crisis” phenomena may not have been significantly more strict than Priest’s proposed negligence standard. Indeed, it is entirely possible that the previous regime was less strict than an ideal negligence regime, so that expansions did nothing more than move the standard closer to what Priest would consider optimal.

Priest also implicitly assumes that manufacturers have been liable mostly for accidents that they could not have efficiently prevented. He assumes, in other words, that Segment A is small (Figure 5). Again, this assumption can be inferred from his conclusion that courts, by awarding nonpecuniary-loss damages, have created harmful insurance effects, but have not generated beneficial deterrence effects. Arguably, however, to the extent that the liability standard has expanded, nonpecuniary-loss damage awards were likely to have been comparatively low in cases in which the manufacturer could not have prevented the accident. Put differently, it seems plausible that nonpecuniary-loss damage awards have been disproportionately high for injuries that the

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It may be, however, that the increase in average damage awards caused the increase in claims to stabilize at a higher level than previously, not because the liability rule has expanded, but rather because a greater number of preventable accidents are now large enough (including nonpecuniary losses) to justify going to court (that is, high fixed-cost threshold is now met for a greater percentage of accidents). Accidents that were not worth litigating under the old regime because the outcome was small or uncertain may be worth litigating under the new regime because the larger expected damages make it worthwhile. See supra note 99.

192. If the internalization of nonpecuniary losses did cause the crisis phenomena, it may be easier to understand why many commentators argue that the current liability standard is still the old negligence rule, see supra notes 16 & 84 and accompanying text, while others insist that liability has been expanding, see supra notes 1 & 14 and accompanying text. If nonpecuniary losses were included in damage awards and negligence determinations, manufacturers would be held liable more often than they would under a negligence rule that included only pecuniary losses in damage awards and negligence determinations.

193. See Priest, Accident Rate, supra note 47, at 221-22 (suggesting that the old negligence regime was not strict enough).

194. See supra notes 84-87 and accompanying text.
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manufacturer could have prevented.195 If this is true, then even if Segment B is significant in terms of the number of product-caused injuries for which manufacturers are liable, the overall significance of segment B may nevertheless be slight, because nonpecuniary-loss damage awards in those cases would likely be disproportionately low.196 Yet, as explained below, even if Priest is correct in his empirical assertion that there has been a significant expansion in manufacturer liability such that Segment B is non-trivial and Segment A is small, he may nevertheless be incorrect to conclude that the impact of such an expansion was deleterious to the insurance and deterrence goals of products liability.

2. Compensation for Nonpecuniary Losses in a Regime More Strict than Negligence

a. The Insurance Effects

Priest argues that nonpecuniary-loss damages have not furthered the deterrence goal and that consumers do not demand insurance against the risk of nonpecuniary losses, so the law should not force it upon them.197 Put differently, Priest’s conclusion that nonpecuniary-loss damages have been harmful rest on two basic claims: (1) that they have served no deterrence benefit; and (2) that consumers do not demand insurance for them.198

195. Cf. S. SHAVELL, supra note 67, at 134-35 (describing when nonpecuniary-loss damages are awarded). A victim of a product-caused injury may endure greater pain and suffering when the injury-producing accident was preventable by the manufacturer. That is, an accident victim may suffer more grief knowing that the accident was not a random act of fate but instead an occurrence that could have been, but was not, avoided; cf. R. COOTER & T. ULEN, supra note 1, at 335, 338 (suggesting that damages may vary depending on the degree of “moral opprobrium” attached to the liability); Ellickson, Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land-Use Controls, 40 U. CHI. L. REV. 681, 761 (1973) (describing losses from zoning regulation: “The situation is aggravated, from a fairness standpoint, by the aggrieved [party’s] knowledge that [the losses] are not random”); Michelman, Property, Utility, and Fairness: Comments on the Ethical Foundations of Just Compensation Law, 80 HARV. L. REV. 1165, 1216 (1968) (describing “currently observable social practices pertaining to compensation” in takings cases; “[...one clear characteristic of current practices is their reflection of a special urgency in the demand for publicly financed compensation when a loss has evidently been occasioned by deliberate... actions.”); id. at 1233-35 (where a program is obviously cost-justified, it is easier for victims to accept than where the program is not obviously cost-justified; therefore, compensation in a takings claim should, for fairness reasons, more likely be mandated when loss was obviously inefficient); Rea, Nonpecuniary Loss, supra note 77, at 42 (courts more likely to award nonpecuniary losses for accidents that were more obviously negligently caused); Rheingold, The Expanding Liability of the Product Supplier: A Primer, 2 HOFSTRA L. REV. 521, 531-32 (1974) (plaintiff more likely to prevail when defendant is shown to have done something wrong).

196. In terms of Figure 3, the authors are suggesting here that insofar as there has been an expansion beyond negligence toward enterprise liability, manufacturer liability has looked more like A + B + D + E + F.

197. Priest, Insurance Crisis, supra note 19, at 1553. Many scholars agree. See, e.g., S. SHAVELL, supra note 67, at 153-54, 228-35, 245-54; Cook & Graham, The Demand for Insurance and Protection: The Case of Irreplaceable Commodities, 91 Q. J. ECON. 143 (1977); Danzon, Tort Reform, supra note 33, at 524; Rea, Nonpecuniary Loss, supra note 77. But see S. Croley & J. Hanson, Insuring Against Nonpecuniary Losses (unpublished manuscript) [hereinafter S. Croley & J. Hanson, Nonpecuniary Losses].

198. For further critique of the second proposition, see Hanson & Logue, supra note 73, at 182-89.
Priest makes the following argument in support of his claim that no consumers would want insurance coverage for nonpecuniary losses:

For purposes of insurance . . . an award [including both pecuniary and non-pecuniary losses such as pain and suffering] is far greater than the level of compensation insurance benefits that any consumer would want. . . . [T]here is no consumer demand for pain and suffering coverage in any insurance market in the world because pain and suffering losses do not affect the marginal value of wealth which is the purpose of insurance.199

But this claim seems too strong. Some consumers appear not only to want nonpecuniary-loss insurance, some have actually purchased it.200 And there is no dispositive theoretical justification or empirical support for Priest’s assertion that nonpecuniary losses do not affect a person’s marginal utility of wealth.201

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199. Priest, Modern Reform, supra note 17, at 16; see also Priest, Insurance Crisis, supra note 19, at 1553; Priest, Liability Crisis, supra note 47, at 5; Priest, Compensation, supra note 25, at 139.

200. See Danzon, Tort Reform, supra note 33, at 522-28 (recognizing that insurance for pain and suffering may well exist). E.g., 1989-90 Student Accident Insurance Protection, underwritten by the Equitable Life Assurance Society of the United States (on file with authors) [hereinafter Student Accident Insurance plan] (offering death, dismemberment, and loss-of-sight benefits, in addition to health benefits, to students); 1990 Amex Life Assurance Company, American Express Group Accident Protection Plan (on file with authors) [hereinafter Amex plan] (offering “loss of life” and “personal bodily loss” insurance for parents and children); Federal Employees’ Group Life Insurance: A Description and Certification of Enrollment in the FEGLI Program (on file with authors) [hereinafter FEGLI plan] (“Accidental Death and Dismemberment Benefits” for employees are feature of “Basic Life” plan and are doubled under “Option A—Standard” plan). Under the FEGLI plan, life insurance benefits are doubled if the death is accidental. But pecuniary losses are no greater in those circumstances. Perhaps the justification for this otherwise inexplicable distinction is that accidental deaths are more likely to result from injuries that cause more significant pain and suffering. The extra “benefits are payable . . . if you receive bodily injuries solely through violent, external, and accidental means . . . .”

201. Other scholars recognize that pain and suffering might affect an individual’s marginal value of wealth. See S. Shavell, supra note 67, at 133-35; Schwartz, Proposals, supra note 10, at 408. The empirical evidence is consistent with either view. As a theoretical matter, it is unclear whether a nonpecuniary loss will increase, decrease, or leave unchanged a person’s marginal utility of income. The answer may vary according to the person’s utility function, the size of the loss, the probability of the loss, the nature of the loss, and so on. S. Shavell, supra note 67, at 228-30; Danzon, supra note 33, at 521; Donahue, The Law and Economics of Tort Law: The Profound Revolution, 102 Harv. L. Rev. 1047, 1065 (1989); Schwartz, Proposals, supra note 10, at 363-64. Priest bases his claim that there is no consumer demand for nonpecuniary-loss insurance on his own intuition and on the inference he draws from his empirical claim that consumers do not have nonpecuniary-loss insurance. But the fact that a consumer has no insurance may say nothing about whether her marginal utility of income would be unaffected by a costly injury. Based on analogous reasoning one could argue that pecuniary damages should not be awarded to individuals who do not carry first-party insurance against pecuniary losses. Cf. Levmore, Self-Assessed Valuation Systems for Tort and Other Law, 68 Va. L. Rev. 771, 810-19 (1982) (courts should use the amount for which injured plaintiff insured herself when buying accident insurance as the sum to compensate her for tortious harm).

Moreover, as a theoretical matter it is not clear that a consumer’s insurance goal is to equalize the marginal value of income across states of the world, as scholars who have argued that rational individuals would not insure against nonpecuniary losses have assumed. The conventional wisdom is that an insurance purchaser’s aim is to equalize her marginal utility of money across different states of the world, based on the assumption that a rational individual will seek to maximize her total utility summed across all possible states of the world. See sources cited supra note 197; see also Arrow, Insurance, Risk, and Resource Allocation, in Essays in the Theory of Risk Bearing 212-16 (1971). Maximizing total utility across different states of the world requires equalizing one’s marginal utility of money across those states. But, instead of maximizing total utility summed across different states of the world, individuals might seek to equalize utility across different states of the world. Such an insurance strategy would require moving money
Consider the metaphor that Priest offers in support of his claim. Priest suggests that consumers do not demand nonpecuniary-loss insurance because money damages for "pain and suffering or other emotional losses" are an "imperfect anesthetic."²⁰² His point seems to be that rational people would not spend their money to mitigate pain when the pain reliever is less than perfect. But there is no such thing as a perfect anesthetic. Still, most patients do not prefer ex ante that their doctors withhold even expensive pain relievers.

If Priest is correct that juries and judges commonly award damages for nonpecuniary losses even when there is no deterrence benefit to be gained from such awards, then perhaps juries and judges, and not just plaintiffs, believe that money relieves the pain resulting from nonpecuniary losses, even if very imperfectly. If anything, the metaphor suggests that there is consumer demand for nonpecuniary-loss insurance.

Moreover, the prevalence of nonpecuniary-loss damage awards may contradict Priest's claim that consumers do not, ex ante, demand nonpecuniary-loss damage awards. Priest contends that the "absence" of first-party nonpecuniary-loss insurance evidences an absence of consumer demand. But Priest's view raises difficult questions. If permitting nonpecuniary-loss damages is as harmful as he and others contend, and if the intuition that individuals do not demand insurance for nonpecuniary losses is widely and strongly held, then why do judges and juries so commonly award them? Why do jurors not recognize the supposed dangers to all consumers (including the jurors themselves, their families, and their friends) of awarding nonpecuniary-loss damage awards? In short, it is unclear why they would consistently act in a way that conflicts with social interests as well as their own intuitions and self-interests.²⁰³

Again, Priest suggests that if consumers demanded insurance against the risk of nonpecuniary losses, first-party insurers would supply it. This suggestion, however, disregards several significant impediments to a market for nonpecuniary-loss insurance, impediments that together can explain the lack of supply. To begin with, consumers ex ante have very little of the information (via insurance premiums) from the non-injury state of the world to injury states of the world beyond the amount necessary to insure fully against pecuniary losses. This is true because in an injury state of the world where an individual has suffered a nonpecuniary loss, the individual's total utility is, because of the nonpecuniary loss, less than in the non-injury state of the world, even after having recovered for all pecuniary losses. If utility is to be spread more evenly across the non-injury and injury states of the world, "extra" money must be moved into the injury state of the world. Granted, this may require some "sacrifice" of total utility summed over the non-injury and injury states of the world. But the extent to which a rational individual will seek to maximize total utility across states of the world, and the extent to which a rational individual will seek to equalize total utility across states of the world are, where there is a tradeoff between the two, unclear. In this light, the conventional argument against awarding nonpecuniary losses on the ground that consumers would never demand insurance against such losses is attenuated. This issue is pursued in more detail in S. Croley & J. Hanson, Nonpecuniary Losses, supra note 197.

²⁰². Priest, Insurance Crisis, supra note 19, at 1547; see also Epstein, Insurance Market, supra note 1, at 653 ("money is an unsatisfactory substitute for health or wholeness"). See supra note 139.

²⁰³. One anticipated objection to this argument is that juries are moved by impassioned appeals to the plight of an injured plaintiff by the plaintiff's counsel. This may be, but the courtroom-drama explanation goes only so far. In general, consumer groups representing the interests of consumers as a whole rather than the interests of particular plaintiffs favor the awarding of nonpecuniary-loss damages.
they would need to write reasonably complete contracts. There are an infinite variety of accidents that might occur, each of which could lead to an infinite variety of nonpecuniary losses. And yet it is very unlikely that a given insured will experience a significant nonpecuniary loss of any type during a contract period. Ex ante, then, there is a low probability of a nonpecuniary loss and, should one occur, a great deal of uncertainty about the nature and severity of that nonpecuniary loss. Insureds have too little information to form a reasonably complete contract, and the costs of obtaining the information ex ante may well swamp the benefits.

There are important differences between the market for nonpecuniary loss insurance and, say, the market for health insurance. First, there is a clear market for health care, and health insurance premiums can be indexed to price levels in that market. To put the matter another way, expected health-care costs may be insurable not because they are pecuniary, but because they are knowable. In contrast, there is no market and no price index for nonpecuniary losses. Insurers have little actuarial data with which to measure consumers’ expected nonpecuniary losses, and have less-than-optimal incentives to collect such data. This is true not just because there is no market index to refer to, but also because of the free-rider problem that often plagues insurance markets. Given the contracting obstacles, insurers who want to respond to the demand for nonpecuniary-loss insurance are left with two choices. They could offer open-ended coverage, the terms of which would not be clear until the insured made a claim. A health insurance contract, for example, might be altered to include compensation for the nonpecuniary element of any insured loss. Even assuming insurers would know what premium to charge for such coverage, they would still probably face insurmountable adverse selection and

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204. Cf. R. COOTER & T. ULEN, supra note 1, at 380 (describing difficulty of measuring nonpecuniary losses); A. SCHWARTZ & R. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 194 (1982) (consumers “may often be unable to estimate accurately the probability of incurring consequential damages . . . . Consumers are relatively uninformed about the effects and their potential costs.”).

205. Cf. W. LANDES & R. POSNER, supra note 57, at 280 (“Contracts are costly to make and . . . the costs may well exceed the benefits, relative to regulation by tort law, when the contingencies that would be regulated by contract—death or personal injury from using a product—are extremely remote.”); O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 70 (1985) (transaction costs of explicitly contracting for a given contingency may exceed the benefits); MacNeil, Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law, 72 NW. U. L. REV. 854, 900 (1978) (long-term, complex contracts become dysfunctional if too rigid); Schwartz, Proposals, supra note 10, at 371 (costs of creating nonstandard nonpecuniary-loss insurance contract will almost always exceed the gain to the insured, and therefore the price he is willing to pay); Shavell, Damage Measures for Breach of Contract, 11 BELL J. ECON. 466, 468 (1980) (“Because of the costs involved in enumerating and bargaining over contractual obligations under the full range of relevant contingencies, it is normally impractical to make contracts which approach completeness.”).

206. See P. HUBER, supra note 1, at 137 (“No insurer could ever accurately assess [nonpecuniary losses] in advance.”).

207. See generally Hanson & Logue, supra note 73. Cf. J. Hanson, The Market’s Failure to Provide Voluntary Hospitalization Insurance from 1930 to 1940: An Empirical Test of the Retardation Hypothesis at 26 (unpublished manuscript on file with authors) (insurers were inefficiently slow in responding to demand for medical insurance, in part because of the disincentive to invest in new data and new ventures given the threat that free-riding competitors would expropriate the gains).
moral hazard problems. \textsuperscript{208} The moral hazard and adverse selection problems stem in considerable part from the fact that once a claim is made, insurers are asymmetrically uninformed about the value of the loss and there are no reliable, disinterested appraisers available to measure the nonpecuniary damages. \textsuperscript{209}

Alternatively, insurers might get around some of these contracting problems by offering small, fixed amounts of coverage for losses that all insureds value greatly. \textsuperscript{210} For example, first-party health insurers might contract to pay, say,

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\textsuperscript{208} See P. DANZON, supra note 22, at 118-36; Schwartz, Proposals, supra note 10, at 365; Session One, Discussion of Paper by Richard A. Epstein, 10 CARDDOZ L. REV. 2227, 2233 (1989) [hereinafter Discussion Session One] (remarks by Epstein) ("Clearly an unbounded recovery of consequential damages introduces a moral hazard problem of serious dimensions.").

\textsuperscript{209} Such problems would arise any time an insurer agreed ex ante to pay more than market value for a loss. Imagine the difficulties of providing insurance for the amount above market price that, say, teddy-bear lovers value their bears. If X values his bear at $1000 even though the next highest bidder would only pay $10 for it, an insurer would not be able to fully compensate X if the bear were destroyed. Because the loss is nonverifiable, the insurer could pay only $10. If insurers compensated X any more than that, nothing would prevent Y, an unsentimental opportunist, from buying a bear on the market for $10, buying teddy-bear insurance, and then torching the bear. Insofar as insurers compensate insureds an amount over market price, they effectively create an arbitrage opportunity, thereby rendering the insurance unworkable. To be sure, insurers might—as they do with fire insurance for arson and with life insurance for suicide—limit recovery to those cases in which the insured item was destroyed "by accident." See, e.g., FEGLI plan, supra note 200 ("Payment to accidental death or dismemberment will not be paid if your death or loss is caused . . . by or as a result of intentional self-destruction or intentional self-inflicted injury . . . ."). But this is only a partial solution, for it is sometimes difficult to distinguish non-accidental from accidental losses.

\textsuperscript{210} Reliable, disinterested appraisers sometimes provide a solution in similar contexts. For example, parties to construction contracts often rely on architects, as independent experts, to determine many aspects of contractual performance. See MacNeil, supra note 205; cf. Michelman, supra note 195, at 1215-18 (explaining the "problem of appraising demoralization costs."). Professor Ellickson often notes that disinterested appraisers are rare even in thicker markets such as the real estate market. Robert Ellickson, Class Lectures (Spring Term, 1990). Cf. Haddock, McChesney & Spiegel, supra note 77, at 1 (the efficiency of legal rules may depend on "thickness" of underlying market). Appraisal values will tend to favor the interests of the party that hired and paid the appraiser, especially in markets in which a market price cannot be readily ascertained. Cooter, The Objective of Private and Public Judges, 41 PUB. CHOICE 107 (1983); see also Wilkinson, Analyzing Third-Party Neutrals, NAT'L L.J., July 16, 1990, at 15-16 (describing the importance and difficulty of obtaining third-party neutrals for successful alternative dispute resolution). With regard to medical care costs, insurers rely in large part on doctors to diagnose and treat injuries. This may pose a problem, however, insofar as doctors have an interest in maximizing their own profits and, therefore, in providing more care than is necessary at higher than competitive prices. Indeed, some believe this problem contributed to the drastic increases in the cost of medical care of late. See generally A. ENTHOVEN, supra note 126. Still, the problem is not as great for the costs of medical care as it would be for nonpecuniary costs. First, there is some competition among providers so that there are limits on a physician's ability to raise prices above the competitive level. R. EVANS, STRAINED MERCY: THE ECONOMICS OF CANADIAN HEALTH CARE 69 (1984); P. FELDSTEIN, HEALTH CARE ECONOMICS 393-409 (2d ed. 1983); P. STARR, THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE 379-420 (1982). Likewise, the insurance companies themselves have enough actuarial information regarding the costs of various medical treatments (from, for example, diagnostic related groupings and health maintenance organizations) to place meaningful but reasonable limits on the prices that physicians can charge. Greeney, Competitive Reform in Health Care: The Vulnerable Revolution, 5 YALE J. ON REG. 179, 185 (1988).

Moreover, physicians themselves are "licensed professionals," who have sworn to abide by certain rules of ethics and, in effect, to ignore the profit motive. See Arrow, Uncertainty and the Welfare Economics of Medical Care, 53 AM. ECON. REV. 941, 966 (1963); J. Hanson, A Modified Public-Interest Theory Explanation of Physician Licensure (unpublished manuscript on file with authors).

210. Some scholars argue that the absence of demand for nonpecuniary-loss insurance is indicated by the fact that parents do not purchase insurance against the risk of losing a child, although the market could and would supply such insurance if it were demanded. See, e.g., Schwartz, Proposals, supra note 10, at 365. There are several problems with this argument, however. First, such insurance does exist although it may be less common than some other forms of first-party insurance. For example, fourteen percent of all ordinary life insurance policies are for the lives of children under the age of fifteen, and the average benefit of these policies is $22,000. LIFE INSURANCE FACT BOOK 12 (1988). See, e.g., policies cited supra note 200. Second, if such insurance were ubiquitous, these scholars might assert that it was for only pecuniary-loss insurance. That is, it is possible that some portion of all life insurance is nonpecuniary-loss insurance.
$2,500 for the nonpecuniary component of losing a hand. Insurers could offer an assortment of contract options to insureds, and ex ante each insured could choose within a given range how much coverage they want for any of several possible losses (e.g., loss of a leg, loss of an eye, and so on) and pay accordingly. In fact, much of the nonpecuniary-loss insurance currently available, takes precisely that form.\(^{211}\) For several reasons, however, even this contract solution is incomplete. First, to the extent that the insurance coverage must be reduced to prevent the arbitrage opportunities described above, benefits to consumers of having the insurance will likewise be reduced.\(^{212}\) Second, the

Scholars intent on denying the existence of demand for nonpecuniary-loss insurance, however, tautologically assert that life insurance only covers pecuniary losses. This claim would seem less plausible with regard to children's life insurance. Cf. R. COOTER & T. ULEN, supra note 1, at 331 ("The death of a dependent generally entails no loss of income to the rest of the family; on the contrary, the death of a child saves the family the expense of raising him or her. This fact once posed a difficult problem for courts: they wished to confine compensable damages to economic losses that are measurable, and yet there are usually no such losses for the death of dependent children."). Regardless of whether children's life insurance would be to cover pecuniary or nonpecuniary losses, such insurance may be less common for unrelated reasons.

The authors' view is that children's life insurance is rare because it would violate certain fundamental social norms. Cf. G. CALABRESE & P. BOBBITT, TRAGIC CHOICES 49 (1978) ("the market sometimes fails when it too clearly prices that to which we would like to ascribe infinite value"); R. COOTER & T. ULEN, supra note 1, at 351 ("Are compensatory damages for the wrongful death of a child an amount of money such that the parents would just as soon have the money as the child? This way of speaking is callous and offensive to parents. It makes no sense to describe the damages given for the wrongful death of a child as 'compensation.'"); id. at 379 ("The idea that a person could be 'indifferent' between a sum of money and a child is repugnant."); id. at 382 (suggesting that there are "legal and moral barriers" to markets for such nonpecuniary-loss insurance). If parents have enough money to buy life insurance, there is social pressure on them to buy life insurance on their own lives for the benefit of their children. Cf. A. MARSHALL, PRINCIPLES OF ECONOMICS 228 (1922) ("men labor and save chiefly for the sake of their families and not for themselves").

There may be an efficiency explanation for the existence of this social pressure. The pressure helps ensure that parents provide sufficiently for their children in case the parents pass away prematurely. Society, then, will not have to pay the costs of raising such children. Life insurance, in essence, forces parents to internalize the costs of bringing a child into the world even when the probability of their death reduces the expected costs of raising a child. Hence, society will encourage parents to purchase life insurance of this sort to optimize the number of children and to reduce the probability that society itself will have to pay those costs through some administratively costly transfer scheme. Conversely, there are strong social pressures against parents purchasing life insurance on the lives of their children. This may be true because society tries to create a safe environment in which there is no incentive for parents to take inefficient risks with the lives of their children. Cf. Tyler, Can Law Save the Children? NAT'L L.J., July 16, 1990, at 13-14 (describing tension facing judiciary between "fundamental notions of family autonomy and the necessity for public responsibility for the most defenseless."). It seems doubtful that many parents would deliberately take the lives of their children (thereby contravening criminal laws), but parents may take, or allow their children to take, greater risks with their children's lives if such insurance is available. See Epstein, Insurance Market, supra note 1, at 653. Because society cannot monitor these sorts of decisions very closely, society wants to avoid giving bad incentives. Therefore, insurers and insurance regulators may be especially cautious regarding the supply of life insurance on the lives of children, and social forces may constrain consumer demand. Heightened regulation of markets that might otherwise cause harm particularly to children is not uncommon. See, e.g., G. EADS & P. REUTER, supra note 145, at 49 n.57 ("[T]he act creating the National Highway Transportation Safety Administration explicitly accepts the idea that purchasers can be allowed a choice with respect to the degree of safety in automobile construction. On the other hand, products affecting infant safety, such as toys, are generally subject to stringent safety standards. "). Consistent with this story is the fact that when insurance companies do offer this sort of insurance on young children they do so primarily for times when the children are outside of their parents' control. For example, life insurance is commonly made available to cover children when the children are at school or summer camp. See, e.g., Student Accident Insurance plan, supra note 200; Athletic Accident Insurance Program, underwritten by All-American Life Insurance Company (on file with authors) (offering insurance for death, dismemberment, and medical expenses to parents of student athletes for accidents that occur during games, practice sessions, fund raisers, picnics, and parades). Absent this explanation, it seems odd that parents would want to receive money for the death of their children only when the children die away from home.

\(^{211}\) See, e.g., policies cited supra note 200.

\(^{212}\) See supra note 208 and accompanying text.
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losses must be limited to very clear and discrete categories.\textsuperscript{213} If an insured loses three fingers, for example, or if an insured's entire hand is severely burned, the insured cannot collect. To collect, the insured must "lose a hand."\textsuperscript{214} Ex ante, any attempt to write a fully specified contract regarding nonpecuniary losses or to write what is equivalent in form and function to a liquidated damages clause would be wildly speculative. One or the other parties will end up taking an enormous loss. Moreover, most first-party insurance is provided through group plans in which, potential members need only sign an application in order to join. The added administrative costs of figuring out and filling out a section on nonpecuniary losses could very well be cost-prohibitive.\textsuperscript{215} In short, ex ante contracting does not seem to provide a satisfactory solution to these problems.

This analysis may help explain why the nonpecuniary-loss insurance that does exist takes the particular form that it does.\textsuperscript{216} The contracts are uncomplicated, offering low, fixed amounts of compensation for a small and well-defined set of injuries. The losses to insureds from the injuries seem vastly greater than the insurance compensation (for example, $2,500 for loss of a foot). In sum, the fact that nonpecuniary-loss insurance is fairly uncommon, does not itself imply that consumers do not demand it. Instead, this analysis suggests that despite consumer demand, ex ante contracting difficulties are often large enough to prevent nonpecuniary-loss insurance from being marketed widely.

Fortunately, it may be possible to deal with these contracting difficulties ex post. With hindsight, it is possible to know exactly who the few unlucky parties who experience a nonpecuniary loss are and to know the nature and severity of their nonpecuniary losses.\textsuperscript{217} The problem ex post is that it is not clear who can be trusted to measure the damages. In the products liability context, a manufacturer might offer to pay for the pain and suffering that its products cause. But then once a consumer is injured, the consumer would have an incentive to overstate the pain. Alternatively, the manufacturer might offer to pay if and only if the manufacturer itself assessed the amount to be paid.

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\footnote{213. See supra note 205 and accompanying text.}
\footnote{214. See, e.g., Travel Accident Insurance plan, supra note 96 ("loss means severance of the limb at or above the wrist or ankle or joint"); FEGLI plan, supra note 200, at 8 ("Loss of limb is defined as the loss of a hand or a foot by severance at or above the wrist joint or ankle joint, respectively. Loss of sight, either in one or both eyes, must be total and permanent.").}
\footnote{215. See supra notes 204-05 and accompanying text.}
\footnote{216. See, e.g., policies cited supra note 200.}
\footnote{217. This ex post approach is usefully employed in many contracting contexts. For example, cattle dealers often sell to packers on a "grade and yield" basis. Packers do not pay on delivery, because they cannot at that point discern the quality and quantity of beef the cattle will yield. Once the cattle are slaughtered, the price term is calculated and the contract price paid. See A. Schwart\textsuperscript{z} AND R. Scott, supra note 204 (discussing In re Samuels & Co., 526 F.2d. 1238 (5th Cir. 1976)).}
\end{footnotes}

The benefits of hindsight may explain why Priest and other scholars prefer a negligence rule to a no-liability rule. See supra note 76. A consumer may be unable to determine ex ante the extent of precautions taken by a manufacturer to provide optimally safe products. A negligence regime permits the consumer, in effect, to rely on a contract that is conditional on the manufacturer taking optimal care. Cf. Rea, Nonpecuniary Loss, supra note 77, at 41.
But consumers would be reluctant to accept that option because of the manufacturer's incentive to raise their prices ex ante and then to understate the consumer's loss ex post.\footnote{218}

To measure nonpecuniary losses ex post, consumers ex ante would want an individual whose only interest was in maximizing the welfare of all consumers. And rather than one individual, they would prefer a group of individuals so that the measurement is not skewed by what might be rather idiosyncratic views of one individual. By relying on a group rather than an individual, the idiosyncracies of the individuals within the group are likely to average out somewhat. The variance of awards is thus likely to be reduced.\footnote{219} Ex ante, consumers would want the group to be composed of individuals reasonably similar to the likely plaintiffs, such as other consumers, so that the group could, by observing all the evidence, estimate the plaintiffs' actual pain and suffering with reasonable accuracy and objectivity.\footnote{220} In short, what consumers would want is something close to what they already have in the current products liability system—a jury.\footnote{221} The tort system can be viewed as an

\footnote{218} In response, the market might provide appraisers who would be paid to measure objectively the amount of pain and suffering endured by an injured consumer. However, appraisers would probably offer a highly imperfect response. See supra note 209.

\footnote{219} See Saks, If There Be a Crisis, How Shall We Know It? 46 Md. L. Rev. 63, 76 n.51 (1986) (all else equal, moving from 12 to 6 jurors created greater variance in awards, perhaps by 41%); see also Klevorick, Jury Size and Composition: An Economic Approach, in THE ECONOMICS OF PUBLIC SERVICES: PROCEEDINGS OF A CONFERENCE HELD BY THE INTERNATIONAL ECONOMIC ASSOCIATION IN TURIN, ITALY 75 (M. Feldstein & R. Inman eds. 1977) (juries should be composed of a "portfolio" of viewpoints).

\footnote{220} Cf. Schwartz, Proposals, supra note 10, at 392-96 (explaining that although juries cannot measure a manufacturer's negligence, they can measure the "negligence of real persons").

\footnote{221} The court system is also used in this way in contract cases. As Ayres and Gertner have noted, courts sometimes employ "tailored defaults" as a means of giving the parties to a contract precisely "what they would have contracted for" had contracting costs been lower. Under the RESTATEMENT (SECOND) OF CONTRACTS, courts determine "what the individual contracting parties would have wanted" by deciding what would have been reasonable "in relation to the 'circumstances' of the individual contracting parties." Ayres & Gertner, supra note 141, at 91-92 (footnotes omitted).

Some might insist that judges and especially juries are incapable of making rational decisions in such complex contexts. Cf. Priest, Modern Reform, supra note 17, at 36 ("I am unsure that it is possible to continue to endorse the system of trial by jury in the context of a serious effort to reduce the accident rate"); Priest challenges the grounds upon which "[t]rial by jury in the complex contexts of modern tort law has been largely defended."); see also Sanders & Joyce, supra note 41, at 248 ("Beliefs about jury behavior, more than any other single factor, seem to have fueled tort reform."). Yet, at least for this "gap-filling" role, juries seem perfectly appropriate. Since individual consumers have so little information ex ante, juries would seem to have superior information about what a consumer's preferences were ex ante or at least about what a reasonable consumer's preferences would have been ex ante. Cf., e.g., McCleskey v. Kemp, 481 U.S. 279 (1987) (The core of the jury function is to make "the difficult and uniquely human judgments that defy codification and that 'build discretion, equity and flexibility into a legal system.'"); O'Neill v. Krzeminski, 839 F.2d 9, 14 (2d Cir. 1988) (acknowledging importance of deferential treatment of jury's assessment of damages); Jones v. Atlantic Refining Co., 55 F. Supp. 17, 19 (E.D. Pa. 1944) ("Courts in general are most reluctant to disturb a jury's verdict on the ground of excessiveness where the damages are unliquidated and there is no fixed measure of mathematical certainty. This is particularly significant... in tort actions for personal injuries."); Armit v. Loveland, 115 F.2d 308 (3d Cir. 1940); see also Labaton, supra note 19 (summarizing Henderson & Eisenberg, supra note 41; quoting Henderson: the results of our study "make it clear that the courts are not the savage, horrible system they have been portrayed as by critics who have called for sweeping tort reforms."); id. (summarizing government study completed by General Accounting Office; study "takes issue with the view that product liability lawsuits have become wildly unpredictable and overly generous to victims of defective products;" "damage awards in five states have been neither erratic nor excessive, but in general are consistent with the kind of injury suffered by plaintiffs.").

It should be noted that consumers and consumer groups do not appear to object to the inclusion of nonpecuniary-loss damage awards. Scholars base their claims about what consumers want on arguments that do not seem to have been articulated by consumers. It is primarily manufacturers and insurers who
efficient public response to a market failure: the inability of insurance markets to respond to consumer demand for nonpecuniary-loss insurance. 222

In sum, although consumers may demand nonpecuniary-loss insurance, they cannot satisfy that demand through the market because contracting ex ante for nonpecuniary-loss insurance would be either incomplete or cost-prohibitive. Given those contracting difficulties, it is little wonder that nonpecuniary-loss insurance is marketed in only a limited set of circumstances. Using the tort system to measure and award nonpecuniary-loss damages ex post may solve the problem of unsatisfied demand and thereby increase social welfare. 223

b. The Deterrence Effects

As discussed above, Priest's argument that nonpecuniary-loss damage awards have generated no deterrence benefits fails to the extent that manufacturers have been liable to the same extent in the current regime as they would be in an ideal negligence regime. But even if Priest is correct that the current regime is more strict than negligence (see Figure 5, supra), the inclusion of nonpecuniary losses in damage awards would still have significant deterrence benefits.

are lobbying to change the rules. For instance, in 1986, the Insurance Information Institute spent over $6 million in advertising and other efforts to place the blame of the insurance crisis on the tort system. Herbert, Tort Reform Drive Launched, J. Com., Mar. 19, 1986, at 1, col. 2.

222. The authors' view of the civil jury is analogous to Churchill's view of democracy: The jury is the worst of all possible systems for estimating nonpecuniary losses, except for all the others. Cf. Ayres & Gertner, supra note 141, at 97 n.46 (suggesting that ex post reliance on courts can be efficient); Klevorick, supra note 219 (suggesting that juries perform a "public service"). Other insurance arrangements may exist because insurers can rely on some publicly provided disinterested "appraiser." For example, there are various state and Federal investigators who determine the causes of deaths, fires, and automobile accidents. Accordingly, life insurers can more easily exclude coverage for suicides, property insurers can more easily exclude coverage for arson, and automobile insurers can more easily adjust premiums based on accident rates. Epstein stresses that the availability of commercial flight insurance is made possible in part because insurers can rely on "the elaborate set of institutional arrangements." Epstein, Insurance Market, supra note 1, at 662; see also Priest, Warranty, supra note 47, at 1315 n.100 ("The information on which the medical or accident insurer relies, of course, is frequently a by-product of the activities of other industries, such as the rendering of medical diagnosis or the administration of the traffic laws.").

223. R. EPSTEIN, C. GREGORY & H. KALVEN, supra note 14, at 672; A. SCHWARTZ & R. SCOTT, supra note 204, at 194. Some might argue that this analysis proves too much insofar as it extends beyond the products-liability context and justifies forcing first-party insurers to compensate insureds for nonpecuniary losses against their apparent will. Perhaps, but the argument need not be taken so far. It applies in the products-liability context in a way that it does not in the first-party insurance context. In the products-liability context, the court system—for deterrence reasons—is already mobilized. The parties are already in court and the court is already measuring nonpecuniary losses. This is not the case in the first-party insurance context.

As discussed above, Priest believes that the optimal liability rule would require manufacturers to pay the total costs, including the nonpecuniary costs of consumer injuries resulting from the manufacturers' negligence. See supra Part I(B)(2). He also believes that product warranties would, absent the interference of tort law, optimize deterrence and allocate product risks efficiently between manufacturers and consumers. See generally, Priest, Warranty, supra note 47. It is worth noting, however, that these two views are in tension with one another: product warranties have never allocated nonpecuniary-loss damages to manufacturers even for accidents they could have efficiently prevented. See S. Croley & J. Hanson, Understanding Products Liability, supra note 1. Thus, even from Priest's perspective, it is not clear how one can be sanguine about the quality of manufacturer contracts. Id.
Priest urges lawmakers to abandon the current “strict liability” regime and to adopt his proposed negligence regime instead. Priest’s recommendation is based in large part on his claim that a cost-benefit negligence standard would provide optimal deterrence. There are, however, shortcomings in Priest’s approach. To explicate those shortcomings it is necessary to recall the two types of investments in accident prevention: care-level investments and activity-level investments. Consider, for example, automobile accidents. Drivers can prevent auto accidents in two ways: They can take greater care when they drive, and they can drive fewer miles. Priest, however, recognizes as “preventable” only “care preventable” accidents. Thus he acknowledges that when drivers can reduce by some amount, x, the expected cost of accidents by investing some amount, y, in care (e.g., reducing the average speed driven), then so long as x is greater than y, such care-level investments should be made. But he does not acknowledge that, when drivers can reduce by some amount, x, the expected cost of accidents by investing some amount, y*, in activity (e.g., reducing the number of miles driven and thereby foregoing some benefits of driving), then so long as x is greater than y*, such activity-level investments should be made as well. Yet these two methods of cost-effectively preventing accidents are analytically identical. They are two components of the same general cost-benefit analysis. If the benefits—in the form of a reduction in expected accident costs—exceed the costs of additional care or of reduced activity, then deterrence considerations require that cost-justifiable investments in accident prevention be made.

Legal economists have observed that courts, when conducting negligence analyses, typically ignore the activity levels of defendants and consequently too often spare defendants from liability when the defendants in fact could have efficiently prevented the accident by reducing their activity levels. It is primarily for this reason that legal economists sometimes recommend enterprise liability over negligence, especially when the number of accidents is thought to depend in considerable part on the defendants’ activity levels. And

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224. See supra Part I(A).
225. Priest, Modern Reform, supra note 17, at 7. Indeed, Priest suggests that deterrence under a negligence rule would be superior to that under our current regime. Id. at 23.
226. See Shavell, Strict Liability, supra note 27, at 2. The activity-level effect of a liability rule is the change in the total cost of accidents resulting from a change in the frequency with which the injurer engages in an activity, holding care-levels constant. The care-level effect is the change in the costs of accidents resulting from a change in the amount of care taken by the injurer, holding activity levels constant. See generally R. Coother & T. Ulen, supra note 1, at 368-69; A. Polinsky, An Introduction to Law and Economics ch. 6 (2d ed. 1984); S. Shavell, supra note 67, at 5-32 (same); Landes & Posner, Products Liability, supra note 1, at 538. For earlier discussions of the distinction between activity-level and care-level effects, see Landes & Posner, Tort Law, supra note 27, at 871-77, 904-08; Polinsky, Strict Liability versus Negligence in a Market Setting, 70 Am. Econ. Rev. (Papers & Proceedings) 363 (1980); see also G. Calabresi, The Costs of Accidents 73-75 (1970).
227. See supra notes 65-66 and accompanying text.
228. Priest, Insurance Crisis, supra note 19, at 1536 n.90; Priest, Modern Reform, supra note 17, at 10-11.
229. Donahue, supra note 201, at 1059-63.
230. See, e.g., R. Coother & T. Ulen, supra note 1, at 368-69; S. Shavell, supra note 67, at 25.
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it is because negligence is viewed by legal economists as deficient in this respect that Priest (in order to maintain that negligence and strict liability are equivalent in deterrence terms) must argue that activity-level considerations should be ignored when choosing among products liability standards.

With activity-level deterrence in mind, it is revealing to examine Priest’s description of how a negligence regime would optimize deterrence:

If the principal goal of modern law is to be accident control, how can it best be achieved? Controlling the accident rate is a very simple proposition. There is now a voluminous literature in the law and economics field unanimous in its conclusion that the accident rate can be reduced to the level optimal for the society by asking at trial one simple question: Is it possible to identify any specific cost-effective action that either the injurer or victim could have taken which would have prevented the accident? If so, then liability should be placed on the party that could have prevented the accident most effectively in order to create incentives to take such actions in the future. If no specific action can be identified, then the issue in the case becomes totally one of insurance for the loss. The only question relevant at trial should be, “Could this accident have been practicably prevented prior to its occurrence?” . . . [F]or the objective of accident reduction, everything else is irrelevant.231

Priest’s focus shifts from “accident control” to “controlling the accident rate.” But these two phrases do not seem to mean the same thing. “Controlling the accident rate” involves controlling only care-level investments. The accident rate is optimized, in other words, when the cost of accidents per use of a given product is minimized.232 And this will be the case whenever all cost-justified investments in care have been made. In contrast, “controlling accidents” (that is, deterring accidents)233 involves both care-level and activity-level investments. Accidents are optimally deterred only when both the accident rate and the number of product uses are optimized.234 Having shifted the focus from

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231. Priest, Modern Reform, supra note 17, at 20-21 (citation omitted).
232. Although Priest never explicitly defines “accident rate,” that definition is clearly implied. Moreover, other prominent contributors to the law and economics literature to which Priest refers do explicitly define “accident rate” in this way. See, e.g., W. LANDES & R. POSNER, supra note 57, at 280 n.6 (“accident rate” equals “the number of accidents divided by some measure of use of the product involved in the accidents”).
233. Priest, Compensation, supra note 25, at 127 (defining “accident control” as synonymous with “deterrence”).
234. Elsewhere, Priest seems to acknowledge the distinction between the number of accidents and the rate of accidents. Priest, Accident Rate, supra note 47, at 222 (“There is no empirical evidence whatsoever of an effect of the tremendous expansion of products liability on the number or rate of product-related accidents.”). The following quote further illustrates Priest’s emphasis on the accident rate rather than on accident reduction in general:

The simple way to reduce the accident rate in all product- and service-related contexts is to ask “Was there a specific act that could practically have been taken that would have
"accident control" to "control of the accident rate," Priest has removed activity-level considerations from his analysis. Priest offers a two-part justification for that omission:

There has been some increasing attention in modern decisions to employing liability rules to affect the level of injurer activity by internalizing costs . . . . With respect to the basic structure of modern tort law, however, [this] effect[] easily can be put aside. [I]nternalizing costs to affect activity levels can only be shown to improve social welfare after a study of supply and demand conditions that would dwarf any previously known antitrust investigation. . . . Perhaps at some later point in the refinement of a novel tort law regime, effects on activity levels . . . may become relevant. In the current context, however, they are trivial sidelights in comparison to the central importance of defining a legal regime to control the accident rate and to provide coherent compensation insurance.235

Thus, according to Priest, activity-level effects should be disregarded when choosing among liability rules first because they are costly to measure and second because the benefits of taking them into account are trivial. The latter claim is unsubstantiated; no one knows how empirically significant activity-level effects would be.236 Though perhaps not easily demonstrated, the activity-level effects of a liability rule may well be orders of magnitude greater than the care-level effects that Priest emphasizes.237

The remainder of this Section considers the claim that activity-level considerations are too costly to measure. First, this Section will examine Priest's

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prevented the accident?" If such an action cannot be shown, then attaching liability in the case will not affect the accident rate. The only effect of liability will be an insurance effect for what must be unpreventable loss. For example, if it cannot be shown that the officers of a municipality could have practically prevented a child from falling off a playground slide, then the accident rate will not be affected by holding the municipality liable for the child's injuries. If it cannot be shown that a pharmaceutical company could have practically prevented an adverse reaction to a drug, then the rate of adverse reactions will not be affected by holding the manufacturer liable for the injury. If it cannot be shown that an asbestos manufacturer could have practically lessened the chances of contracting cancer from wartime use of asbestos, then the rate of asbestos injuries will not be influenced by holding the manufacturer liable, nor will the future injury rate from the use of other substances causing cumulative disease, because there will be nothing manufacturers of these substances can do to reduce it.

Priest, Modern Reform, supra note 17, at 21-22.
235. Id. at 9-10; see also Priest, Insurance Crisis, supra note 19, at 1537 & n.90.
236. Indeed, Priest himself has recently noted: "Almost every human action will increase the probability of some loss by some amount; empirically, it would be extremely rare for an action to contribute zero toward the probability of occurrence of all losses in all contexts." Priest, Risk Control, supra note 47, at 215.
237. Consider, for example, the personal injuries that stem from smoking cigarettes. To be sure, a smoker's failure to take care may lead to fires and burns, but it seems likely that the greater costs of cigarette smoking stem from smokers engaging in too much activity. A smoker's risk of contracting lung cancer, for example, probably depends more on the number of cigarettes that person smokes than on the care she takes in smoking them.
claim that courts should disregard activity-level considerations in most tort contexts because of the high costs of determining the efficient activity levels for the parties involved. Second, this Section will show that while his claim may be relevant in other tort contexts, it is irrelevant in the products liability context, except insofar as it undermines arguments in favor of a negligence rule. For simplicity, the remainder of Part III proceeds under the assumption that care levels are optimized.

Outside the products liability context, courts, in choosing among liability regimes, face the option of either altering potential victims' activity levels (under a negligence or a no-liability standard) or altering potential injurers' activity levels (under a strict liability standard). In an ideal negligence regime, courts would alter the activity levels of potential injurers by taking activity levels into account in their negligence determinations. But as mentioned above, scholars of law and economics agree that, in practice, courts do not or cannot take activity levels into account in their negligence analyses. Accordingly, these scholars sometimes recommend strict liability as a means of optimizing the activity levels of potential injurers especially when accident costs are believed to be highly responsive to injurer activity levels.

For example, consider manufacturer-caused accidents where the costs fall only on third parties (that is, persons other than the consumer or the manufacturer). If a manufacturer of electricity provided power to Region A but, as a function of its activity level, spewed noxious fumes into the lungs of third parties in Region B, then under a negligence rule the manufacturer would not internalize those costs. Some scholars have argued that to produce a more efficient outcome courts should hold manufacturers strictly liable for the costs of such injuries.

Figure 6 illustrates how such a rule would lower the costs of accidents by reducing the manufacturer's activity level. A firm's marginal private costs are drawn as the MPC curve, which represents the manufacturer's costs excluding those costs imposed on third parties. The firm's marginal social costs are drawn as the MSC curve. The MSC curve represents the total social costs caused by the firm including the marginal private costs and, c, the costs to the injured third parties in Region B. Finally, demand for the firm's product is drawn as the MSB curve, representing the marginal social benefit associated with each unit of output (activity).

238. Perhaps this is what Priest means when he writes: "With respect to the basic structure of tort law . . . ." See supra text at note 235.
240. See supra note 230 and accompanying text.
241. R. POSNER, ECONOMIC ANALYSIS, supra note 67, at 163; S. SHAVER, supra note 67, at 23.
242. See e.g., Spence, Consumer Misperceptions, Product Failure and Producer Liability, 44 REV. ECON. STUD. 561 (1977); Polinsky, supra note 225; cf. A. Pigou, THE ECONOMICS OF WELFARE (4th ed. 1948) (arguing that manufacturers should be required to pay a tax equal to the costs they impose on others).
Figure 6

Effect of Activity Levels on Costs of Accidents

Figure 7

Effect of Activity Levels on Costs of Accidents
A social loss results because the manufacturer produces beyond the point where the marginal social benefits equal the marginal social costs (that is, beyond the point where MSB intersects with MSC). For each unit of production between \( Q \) and \( Q^* \), the social loss is measured by the difference between the marginal social costs and the marginal social benefits (i.e., MSC - MSB) so that the total social loss can be measured by the shaded triangle DEF. By placing upon the manufacturer the total costs imposed by the manufacturer's activity, the MSC curve effectively becomes the manufacturer's marginal private cost curve. Under such a rule, the manufacturer would—because it has “internalized” the total costs of its activity—produce only up to \( Q \) units of its product. In other words, the manufacturer would reduce its activity levels until reaching the socially efficient level.

Priest's point seems to be that this analysis presumes that courts can determine the relative, long-term values to potential injurers and potential victims of conflicting activities. But as Priest and others have correctly noted, this basic activity-level analysis is incomplete. Courts cannot easily determine whether in the long run there should be less electricity in Region A or fewer people in Region B. Put differently, there seems to be no basis for the conclusion that the manufacturer and not the population of Region B should be required to reduce its activity. Under strict liability, Region B would, in effect, impose a cost upon the manufacturer by forcing the manufacturer to reduce its activity level. And the population of Region B would not internalize that cost as part of its own marginal private cost curve. Unless courts can measure the utility functions of the affected parties, they cannot know which liability rule will lead to the optimal result. Therefore, since courts cannot measure utility functions, they should disregard altogether this efficiency justification for strict liability.

One immediate problem with this argument, however, is that the central point—that courts are incapable of accurately estimating utility functions and supply and demand conditions—is as strong an indictment of Priest's proposal as it is of a standard under which courts must attempt to take activity levels into account. That is, the information required by courts to determine the marginal costs of accident prevention to injurers and victims in the form of increased investments in care is no less expensive or inaccessible than the information required to determine the marginal costs of accident prevention to injurers and victims in the form of increased investments in reduced activity. In either case, courts must, to do their job well, estimate and compare supply

243. See, e.g., W. LANDES & R. POSNER, supra note 57, at 48; R. POSNER, ECONOMIC ANALYSIS, supra note 67, at 162-63; S. SHAVELL, supra note 67, at 29. See generally Coase, The Problem of Social Cost, 3 J.L. & ECON. 1 (1960) (explaining how costs that were traditionally viewed as “external” to defendant activity could instead be viewed as “internal” to plaintiff activity).

244. Cf. Donahue, supra note 201, at 1059-63.
and demand schedules under alternative liability rulings. Thus, if Priest is correct to criticize scholars and courts for employing activity-level justifications in support of strict liability, then he is wrong to ignore the relevance of the same criticism to his proposed cost-benefit negligence standard.

There is a second problem with Priest’s reasoning on this issue. He argues that because courts cannot readily measure utility functions, they cannot decide whether the manufacturer or the population of Region B should have to reduce activity levels. However, he draws the conclusion that lawmakers should therefore ignore the issue of cost internalization when making the choice between strict liability and negligence in the products liability context, where there is a market nexus between manufacturers’ activity levels and consumers’ activity levels. And he applies this conclusion where consumers, not third parties, are the victims of product accidents. Insofar as the activity levels of consumers and manufacturers are linked, however, Priest’s application of this conclusion to claims made by a product’s consumers is misplaced. For claims stemming from injuries to a product’s consumers, courts need not choose between the consumer’s activity level and the manufacturer’s activity level in their application of a liability rule. This conclusion follows only for any product whose useful life is a function of a consumer’s activity level (everything from hamburgers to typewriter ribbons to automobiles). For any product whose useful life is unrelated to a consumer’s activity level (a compact disk, for example), activity-level considerations are as difficult for courts to take into account as care-level considerations are. Of course, if consumers are well informed about product risks and if insurance mechanisms do not distort parties’ incentives, then any liability rule will generate optimal consumer and manufacturer activity levels.

Figure 7 illustrates this proposition. MB* represents consumers’ marginal total benefits when consumers do not have to pay for the marginal cost of product accidents, c, in addition to a given market price. If, in addition to a given market price, consumers must also bear c, then their marginal benefits would be reduced by c to MB’. That is, MB’ represents the amount consumers are willing to pay for the product if in addition to the market price they must also pay c. P* is the total price or marginal cost (MC*) of the product including c. P’ is the price or marginal cost (MC’) excluding c.

Under either a no-liability regime or a negligence regime, manufacturers will not be liable for c. Therefore, under either regime, they will charge P’ (= MC’). The consumers’ demand under this regime is MB’ reflecting the fact

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245. Recognition of this fact underlies Alan Schwartz’s preference for strict liability over negligence. Under strict liability, this costly—if not impossible—analysis need not be conducted. Schwartz, Proposals supra note 10, at 384-92; see Hanson & Logue, supra note 73, at 169-70.

246. Note that this shall be a fundamental qualification of Priest’s argument, because most product-caused injuries occur to consumers. See Hanson & Logue, supra note 73, at 135 n.29.

247. See Shavell, Strict Liability, supra note 27, at 4-6 (making a similar point).
What Liability Crisis?

that consumers must, in addition to the market price, bear \( c \), the expected cost of product accidents. The equilibrium activity level (i.e., where \( MC' = MB' \)) is \( Q_e \), which, as was true in the previous example, is the efficient activity level for the manufacturer.

In an enterprise liability regime (that is, a strict liability regime in the products liability context), manufacturers will be liable for \( c \). As a result, the manufacturer's costs will increase to \( MC^* \) and, accordingly, price will rise to \( P^* \). Under this regime, consumer demand will be \( MB^* \), and, again, the equilibrium activity level (i.e., where \( MC^* = MB^* \)) will be \( Q_e \). Again, \( Q_e \) represents the efficient activity level for manufacturers and consumers.

Assuming that consumers know perfectly their expected losses from consuming each product, any products liability rule will optimize activity levels because of the price nexus between manufacturers and consumers. Courts could flip a coin to choose between liability rules and still ensure optimal activity levels. It is therefore irrelevant whether courts have the ability to determine what the optimal activity levels are.

Priest is mistaken, then, in concluding that courts should disregard the activity-level effects of a liability rule. Because consumers do not know perfectly their expected nonpecuniary losses, the only rule that will optimize activity levels, and hence the only rule that will optimize deterrence, is enterprise liability.\(^{248}\) Only under enterprise liability will manufacturers and consumers, bound together by the price mechanism, both internalize the full costs of their activities.\(^{249}\)

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\(^{248}\) See Hanson & Logue, *supra* note 73; Schwartz, *Proposals*, *supra* note 10, at 405-06.

\(^{249}\) There are several reasons that consumer product markets fail to optimize activity levels or care levels with respect to nonpecuniary losses. First, consumers may tend systematically to underestimate the risk of nonpecuniary loss. Cf. G. Calabresi, *supra* note 226, at 56-58; R. Cooter & T. Ulen, *supra* note 1, at 416; Calabresi & Klevorick, *supra* note 84, at 617 n.88; Judgment Under Uncertainty: Heuristics and Biases (D. Kahneman, P. Slovic & A. Tversky eds. 1981). Second, because of the small probability to each consumer of significant nonpecuniary losses, the information and transactions costs of estimating expected nonpecuniary losses (especially when they would be small) may exceed the benefits to each consumer. Cf. W. Landes & R. Posner, *supra* note 57, at 274; R. Posner, Economic Analysis, *supra* note 67, at 166; Landes & Posner, Products Liability, *supra* note 1, at 544. Third, even if consumers do not systematically misestimate the risk that products pose, there may still be adverse selection and unraveling problems that lead to suboptimal deterrence. See, e.g., Hanson & Logue, *supra* note 73, at 176-77; Akerlof, *supra* note 117. In recommending that nonpecuniary losses be included in his proposed negligence regime, Priest implicitly acknowledges that there exists a market failure with regard to nonpecuniary losses. See *supra* notes 76 & 223 and accompanying text. Otherwise there would be no reason to include them in the negligence determination or damages calculus.

Most legal economists believe that product warranties are efficient, not exploitative, when allocating between manufacturers and consumers the risk of product failures that do not lead to personal injury. From this, they have concluded that contracts allocating the risk of personal injury between manufacturers and consumers would also be efficient, if such contracts were enforceable. See generally S. Croley & J. Hanson, Understanding Products Liability, *supra* note 1. But this conclusion may be unwarranted. Most pecuniary elements of personal injuries are already covered by first-party insurers, so we should not expect consumers to demand (or manufacturers to supply) insurance against such losses with the product. See *infra* notes 252-53 and accompanying text. And the nonpecuniary component of personal injuries would also be very costly to contract for ex ante. See *supra* notes 203-23 and accompanying text.
The above section argued that an expansion in liability standards toward enterprise liability may very well have produced desirable deterrence effects with regard to nonpecuniary losses. This Section, considering only pecuniary losses, shows how such an expansion in liability may have had the effect of shifting the insurance burden from consumers and their first-party insurers to manufacturers and their liability insurers. This Section argues that this shift of the insurance burden produced still more desirable deterrence effects and that the "crisis" phenomena that resulted from the shift were efficient.

As described above, Priest's characterization of the "crisis" phenomena as inefficient, and his advocacy in favor of greater reliance on first-party insurance mechanisms, greatly depend upon his assumption that first-party insurance is efficient. 250 It has recently been argued, however, that first-party insurance, unlike manufacturer-provided insurance, removes from consumers and manufacturers incentives necessary for efficient investment in accident prevention. Consumers are insured through first-party mechanisms against most of the pecuniary risks of product accidents. 251 First-party insurers rarely and imperfectly adjust premiums according to each individual consumer's decisions concerning exactly what products are purchased, how many of each product are purchased, and how carefully those products are consumed. The failure of first-party insurers to adjust premiums according to those "consumption choices" gives rise to the "first-party insurance externality." 252 Through first-party insurance, injured consumers are compensated for many of their losses stemming from product-caused injuries. And to the extent that first-party insurers do not adjust premiums according to consumers' expected accident costs, injured consumers will ignore those costs, externalizing them upon their fellow first-party insureds.

This first-party insurance externality may seriously undermine the deterrence effects of products liability. To the extent that consumers are compensated through first-party insurance, a products liability rule can have only an attenuated effect on consumers' willingness to invest in accident prevention. Consequently, to the extent that manufacturers are not held liable through products liability for all preventable accidents, manufacturers will have little or no incentive to invest in accident prevention. Care levels will be too low, and activity levels too high:

[T]he deterrence implications of this externality . . . can be loosely summarized as follows. Under a negligence regime, manufacturers will

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250. See supra Section I(A).
251. See generally Hanson & Logue, supra note 73.
252. See id.
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make suboptimal investments in product safety, and activity levels will be inefficiently high. Under an enterprise liability regime, on the other hand, manufacturers will efficiently invest in product safety and activity levels will be optimal. Enterprise liability, then, eliminates the insurance externality for these deterrence variables. 253

If correct, this argument suggests that under the previous regime products were inefficiently maintained on the market owing to the first-party insurance externality. As the law shifted toward an enterprise liability regime, consumers and manufacturers were forced to internalize the costs of those products.

The “crisis” phenomena can thus be explained as the inevitable and desirable consequence of internalizing the first-party insurance externality. By expanding the liability rule toward enterprise liability, as Part III(B)(2)(b) explained deterrence considerations require, courts increased the number of successful claims made against manufacturers. Liability insurers were made liable for accidents that they were not liable for prior to the expansion. Consequently, liability insurance premiums have increased. Because some of the product accidents occurring prior to the expansion were preventable, it is understandable that liability insurers not only raised their premiums, but also restructured their contracts, and even withdrew some lines of coverage to induce manufacturers to optimize investments in prevention. 254 And some manufacturers, responding to escalating insurance costs, sought alternative forms of insurance. 255

In light of the first-party insurance externality, it is illuminating to consider the various empirical phenomena that Priest argues can be explained only by his unravelling theory. Priest writes: “No one doubts that [recent expansions of corporate tort liability have led to] substantial increases in tort claims, trials, and damage judgments . . . .” 256 He then argues that the increase in legal judgments “does not explain what it is about the expansion of tort liability that has led to the withdrawal of insurance capacity". 257

The question is especially puzzling because of the curious empirical context of the recent crisis. Two phenomena, in particular, are important here. First . . . there is no evidence of an increase in the rate or severity of accidents for the principle set of activities affected by the crisis. 258

253. Id. at 189-90. This demonstration depends in part on the inability of courts to optimize activity levels or to implement an efficient negligence regime.
254. See infra Part IV(C).
255. See infra Part IV(D).
256. Priest, Tort Reform, supra note 47, at 526.
257. Id. at 527.
258. Priest, Insurance Crisis, supra note 19, at 1551.
Indeed, in virtually all product and service contexts the injury rate has been steadily declining over time. 259

Moreover, the extension of tort liability has not generated totally new insurance coverage. 260

If there has been no increase in the accident rate and if the largest majority of tort law claimants already possess first-party insurance, then the expansion of corporate legal liability has chiefly shifted coverage from (private and government) first-party sources to corporate defendant third-party insurance sources. 261

But these phenomena are easily explained by the internalization of the first-party insurance externality. Because the majority of consumers had first-party insurance, and because that insurance permitted consumers and manufacturers to externalize the pecuniary costs of product accidents, expanding the liability of manufacturers toward enterprise liability has had several major effects.

First, under the previous regime, to the extent that the courts did not hold manufacturers liable for accidents that they could have prevented, 262 the first-party insurance externality led to suboptimal investments in manufacturer care. 263 By shifting the previously externalized accident costs to manufacturers, consumers and manufacturers have been forced to internalize those costs—manufacturers through their increased liability costs and consumers, in turn, through higher product prices. Expanded liability encouraged manufacturers to increase investments in manufacturer care toward the optimal level.

Product prices rose to reflect the increased investments in safety and also the risk of unpreventable product-caused injuries. Consequently, activity levels moved closer to the optimal, 264 and products not worth their true costs were withdrawn. That is, products that had been inefficiently subsidized through the first-party insurance externality were either curtailed or removed altogether.

259. Priest, Puzzles, supra note 47, at 501.
260. Priest, Insurance Crisis, note 19, at 1552.
261. Priest, Liability Crisis, supra note 47, at 5.
262. See supra notes 244-45 and infra notes 263 & 321-29 and accompanying text.
263. This may have been the case for several reasons. For instance, the negligence standard preceding the expansion may have held manufacturers liable too rarely even as compared to a cost-benefit negligence standard. If that were true, expanding liability would have the effect of increasing the percentage of initially preventable accidents for which manufacturers were liable. But the negligence standard need not have systematically favored manufacturer-defendants for the manufacturers to have had suboptimal incentives to invest in care prior to the expansion. So long as the negligence regime was sufficiently random such that a court's finding of negligence was sufficiently independent of whether the manufacturer was actually negligent, products liability would have little influence on manufacturer decision-making. This would be the result if courts were unable to apply a negligence standard. See S. Sugarman, supra note 39, at 7; Schwartz, Proposals, supra note 10, at 386-88 (arguing that courts cannot apply negligence standard); Hanson & Logue, supra note 73, at 169-70 (same); see also supra notes 244-45 (explaining how Priest has unwittingly argued that courts cannot apply negligence standard). The evidence appears to comport with this view. See G. Eads & P. Reuter, supra note 145, at 17-18, 124; Rea, Nonpecuniary Loss, supra note 77, at 41-42; see also Priest, Accident Rate, supra note 47, at 221-22.
264. See supra Part III(B)(2)(b).
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The internalization of the externality could well be responsible for any decrease in the accident rate, an empirical phenomenon that Priest often highlights, but for which his theory does not readily account. Indeed, Priest's analysis may confuse cause and effect.\(^\text{265}\) He maintains that because the accident rate has decreased, there is no good reason for the increase in the number of tort awards. The authors' view is that precisely because of the increase in the number of tort awards, the accident rate has decreased. That reduction helps justify the expansion inasmuch as it reflects improved deterrence.

Consider Priest's empirical description and assessment of the process of product withdrawal:

The insurance changes generated drastic responses from product manufacturers and service providers. Prices were increased to offset increased premiums. Firms and entities denied insurance coverage were forced to curtail operations. . . . Even the nation's largest corporations were affected—those whose size and self-insurance capacity make them least vulnerable to changes in commercial insurance markets. A survey of the 500 largest public corporations revealed that twenty-five percent had removed products from markets for liability reasons.\(^\text{266}\)

The point is that, for some products and services, insurance pools could be maintained on a first-party basis that could not be maintained on a third-party basis . . . . It is for these products and services that the expansion of tort liability . . . is most harmful.\(^\text{267}\)

The failure of the insurance enterprise in these commercial lines . . . is an artifact of the form of insurance delivery. . . . [T]he problem has arisen because insurance markets which could be supported by a first-party insurance mechanism, cannot be supported by a third-party tort law mechanism.\(^\text{268}\)

The large number of products and services that have been totally withdrawn from markets demonstrates the severity of the effects of contemporary tort law's shift to third-party insurance mechanisms.\(^\text{269}\)

\(^{265}\) Huber appears to do the same. See P. HUBER, supra note 1, at 161 ("There is hardly a product in use today . . . that is not many times safer than its counterpart of a generation or even a decade ago.").

\(^{266}\) Priest, Liability Crisis, supra note 47, at 2; see also Priest, Understanding the Crisis, supra note 47, at 196; Priest, Insurance Crisis, supra note 19, at 1567 ("Very recently, a Conference Board survey of the nation's 500 largest corporations showed that twenty-five percent had removed products or services from markets.").

\(^{267}\) Priest, Insurance Crisis, supra note 19, at 1569.

\(^{268}\) Priest, Compensation, supra note 25, at 140.

\(^{269}\) Priest, Insurance Crisis, supra note 19, at 1567.
Priest's empirical description here may be unexceptionable. It does not follow, however, that products maintained under the previous regime but withdrawn under the expanded regime reflect a shift from efficient to inefficient insurance mechanisms and provide a measure of the severity of the "crisis." Indeed, the fact that products had been maintained under the previous regime but not after the expansion may instead evidence the deterrence benefits of a more expansive liability regime and provide a measure of the severity of the first-party insurance externality. Part IV below examines this possibility further.

D. Socio-Legal Uncertainty

Unpredicted changes in liability can create socio-legal uncertainty that is independent of the size of risk pools and that is not easily diversified even through the stock market. Most commentators contend that this increase in socio-legal uncertainty may be responsible for many of the "crisis" phenomena. The authors do not dispute this. Socio-legal uncertainty may help explain many of the "crisis" phenomena that are related to changes in liability insurance markets. While there may be some canceling out of risk terms the more firms and industries there are represented in any given insurance pool, if the liability standard becomes more strict, risk terms may not cancel insofar as they move systematically. If there has been an unpredictable shift toward enterprise liability, then, insurers are faced with significant socio-legal risk.

If they charge insureds according to each insured's expected liability, the insurers face roughly a fifty percent chance of losing significantly on all their contracts. Because of that risk, liability insurers must withdraw coverage

270. See P. DANZON, supra note 22, at 91 (describing effects of socio-legal risk on medical malpractice insurance market); Epstein, Insurance Market, supra note 1, at 664 ("[T]he present law exposes the manufacturer to systematic risk. One obvious concern is that any shift in the liability rules, such as we have just witnessed, can impose an enormous undiversifiable risk on products liability insurers that is not found in, for example, life insurance."); Trebilcock, Insurance-Deterrence Dilemma, supra note 38, at 929; Viscusi, Wading Through, supra note 16, at 17-18 (making a related point about the difficulty of insuring highly correlated risks, as in the asbestos industry); Winter, supra note 39, at 456 ("The feature of the liability insurance market that is critical for explaining the [crisis] is the substantial uncertainty that insurers face in predicting claims."); see also TORT POLICY WORKING GROUP, 1987 UPDATE, at app. 19-22 (discussing socio-legal risk).

271. Liability insurers' reaction to this risk may be a function of the types of decision-makers that are in the insurance industry. That is, the insurance industry was historically a relatively risk-free industry. Accordingly, there may have been a sort of self-selection into the industry of individuals not interested in, and not good at, dealing with risk. Insurance executives, in other words may be lacking in entrepreneurial zeal. This hypothesis is consistent with the fact that some of the industries first to leave the stock insurance pools and to self-insure were industries where high levels of risk are common. The authors are indebted to Guido Calabresi and Henry Hansmann for raising this possibility.
altogether or increase their premiums to a level beyond the increase in expected payouts.272

But the observation that socio-legal uncertainty may account for some of the crisis phenomena does not further the debate over what makes for the optimal liability regime. If it is true that the unpredictability of the changes in the liability regime is to blame for "crisis" phenomena, that fact does not tell courts and legislatures which liability rule to adopt in response. It argues only that courts should not change the liability rule unpredictably, all else equal. In this light, it seems ironic that commentators concerned with the effects of socio-legal uncertainty have called for dramatic changes in the liability rule.273 Arguably, if socio-legal uncertainty is a problem, commentators should be trying to minimize rather than to instigate change.

As explained below,274 in the authors' view the long-term harm stemming from socio-legal uncertainty is de minimis because manufacturers can eliminate (and have eliminated) its effect at reasonably low cost. To the extent that socio-legal uncertainty remains undiversifiable, however, the best policy response may well be for lawmakers to adopt and stick with an enterprise liability regime.275

E. Summary of Part III

Part III has offered an alternative, efficiency explanation for the so-called liability crisis. This Part has argued that there was really no crisis at all, and that the recent events associated with the "crisis" can be explained as the market's reaction to the internalization of the nonpecuniary costs of product accidents, the internalization of the first-party insurance externality, and an increase in socio-legal uncertainty. Section A outlined those phenomena which any account of the liability crisis must explain, and Sections B through D explained the insurance and deterrence consequences of including nonpecuniary losses in damage awards, the effects of internalizing the first-party insurance externality, and the effects of socio-legal uncertainty, respectively. It is now necessary to evaluate the alternative explanation vis-à-vis Priest's explanation by comparing the competing theories' explanatory powers.

272. Priest, Insurance Crisis, supra note 19, at 1544; see also Tort Policy Working Group, 1987 Update, supra note 1, at 51 ("Because insurers cannot assess their risk with any degree of certainty, and in light of the general deterioration of the tort system, their tendency often is to view such risks on an almost 'worst case' basis. As a result, many risks are far more difficult or expensive to insure if the insurer also is faced with the possibility of an open-ended liability which may be virtually impossible to assess and which may expose the insurer to massive, unplanned for liability."); id. at 58 ("Increasingly, insurers and potential defendants find it extremely difficult, if not virtually impossible, to predict liability.").
273. See, e.g., supra note 46.
274. See supra Part II(C)(3).
275. Priest recognizes that socio-legal uncertainty increased as a result of expanding liability rules, and may therefore have contributed to the "crisis." However, he does not emphasize this risk. Priest, Insurance Crisis, supra note 19, at 1563 ("Most important in [this] analysis ... is the effect of the increase in ... corporate liability ... on adverse selection."). Other commentators, however, view socio-legal uncertainty as the most important factor in explaining the "crisis."
IV. Comparing the Unravelling Theory and the Internalizing Theory

A. Introduction to Part IV: The Competing Theories Compared

Priest includes in his discussion of consumer risk pools the bold claim that only his explanation of adverse selection and the resulting unravelling of consumer risk pools can explain the withdrawal of consumer products from the market. He writes:

Adverse selection in consumer risk pools explains why the increase in insurance premiums has been extreme for products and services in recent years. It also provides the only explanation of why increases in corporate tort liability compel providers to withdraw products and services from markets altogether. . . . [I]f there were no adverse selection, increases in insurance premiums or self-insurance costs could largely be passed on to consumers. . . . There is a different effect, however, where a price increase derives from increasing risk pool variance. Increasing variance generates adverse selection by low-risk consumers who successively drop out of the pool. The pool, as a consequence, unravels. At some point, demand for the product sold with the necessary insurance premium simply disappears.276

Priest's assertion that only risk pool unravelling can explain the withdrawal of products notwithstanding, perhaps the most natural explanation is one that he briefly alludes to but otherwise disregards.277 Priest points out that it is important to distinguish, at least analytically, between products and services withdrawn for insurance reasons and for deterrence . . . reasons. Some products or services may simply generate so many injuries that continued production is infeasible. A legal standard that attached liability where the marginal expected injury costs exceeded the marginal costs of preventing the injury (here, the bare cost of production) would be sufficient to drive such products and services from the market and, thus, increase social welfare.278

276. Id. at 1566.
277. The alternative explanation is natural in the sense that it is precisely what the “founders” predicted and hoped would happen following a shift toward enterprise liability. See, e.g., G. Calabresi, supra note 226, at 68-94 (describing general deterrence). Yet Priest sets aside this explanation while accusing the founders of having misunderstood the insurance implications of their proposals. It is also the most natural explanation given that generally when economists describe a product being withdrawn from the market they speak of a manufacturer’s costs increasing until those costs exceed the product’s market price.
278. Priest, Insurance Crisis, supra note 19, at 1569.
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Here Priest recognizes not only that an alternative explanation for the withdrawal of products exists, but also that, were this the best explanation, product withdrawals could be characterized only as socially beneficial—the result of consumers' substitution of relatively unsafe, more expensive products for safer, less expensive products. Priest acknowledges that in the absence of adverse selection liability premiums could have increased and products could have been withdrawn from the market simply because the cost of certain products had risen relative to that of their substitutes.

According to a basic principle of microeconomics, a firm will cease production whenever the average variable costs of producing a product exceed its market price, even in the short run. Priest recognizes that firms behave this way and that such behavior yields a net efficiency gain. However, Priest does not say why this alternative explanation for the withdrawal of consumer products is implausible. Instead, he disposes of this efficiency explanation by concluding that, except perhaps for asbestos, it is difficult to believe that products and services recently withdrawn were withdrawn because of the danger they present. By asserting that only adverse selection can explain the withdrawal of products and services, Priest assumes what he claims to be proving, namely, that recent product withdrawals were inefficient.

He states, for instance, that “[t]he effect on national income of increased prices and the withdrawal of products and services is obvious.” Obvious? This is the very question. As Part III explained, it is entirely possible that higher prices and fewer products have led to fewer accidents and, therefore, to a net increase in the national income.

This Part challenges Priest's claim that only unravelling can account for rising premiums and product withdrawals. It compares the explanatory powers of Priest's theory of unravelling risk pools—labeled the “unravelling theory”—with the alternative theory set forth in Part III—the “internalizing theory.” Sections B, C, and D reinterpret the empirical evidence that Priest attempts to explain. Section B challenges Priest's account of unravelling consumer risk pools by arguing that the withdrawal of the particular consumer


280. In discussing the aims of antitrust laws, for instance, Priest writes: “Our society wants to remove those products from markets whose production costs (and thus prices) are greater than what consumers are willing to pay in order to reallocate resources to goods whose value to consumers exceeds their costs.” Priest, Antitrust Suit, supra note 47, at 1025.

281. Priest, Insurance Crisis, supra note 19, at 1570; see also Priest, Liability Costs, supra note 47, at 323 (“A central objective of the legal system is to compel the withdrawal of excessively risky products and prevent the introduction of new ones. But is it plausible that 47% of our manufacturers suddenly discovered in 1986 that their products were too dangerous for modern society?”). Elsewhere Priest asserts that “[c]onsumers do not benefit from having fewer products and service choices . . . .” Priest, Insurance Crisis, supra note 19, at 1568; see also Epstein, Unintended Revolution, supra note 1, at 2214 (“[T]here is little reason to think that there are any positive outcomes that result from forcing products off the market that consumers are prepared to purchase.”) (emphasis in original). Again, that claim depends on an unstated assumption that such withdrawals were inefficient.

282. Priest, Insurance Crisis, supra note 19, at 1522.
goods and services Priest mentions is largely attributable to the dangers those
goods and services present. Section C challenges his account of the unravelling
of manufacturer risk pools by arguing that the increase in policy exclusions
and copayment mechanisms are largely attributable to insurers' increased
attempts to ensure that their insureds prevent all accidents that they can prevent
cost-justifiably. Section D also challenges Priest's account of the unravelling
of manufacturer risk pools, arguing that the recent rise of mutuals as the
desirable form of insurance organization is largely attributable to insureds'
response to socio-legal uncertainty.

B. The Withdrawal of Consumer Products and Services

As explained in Part II(B) above, Priest believes that products and services
were withdrawn from the market as a result of high variance of risks within
consumer risk pools. The variance of the risks that consumers within a given
product's risk pool posed, not the average size of those risks, led to consumer
risk pool unravelling. In other words, variance, not product danger, was the
determinant. Thus, a product that caused many consumer injuries, for which
the average risk of the consumer risk pool would therefore be high, would not
have been withdrawn from the market if the variance within that pool was
small. If, on the other hand, risk pool variance for a given product was
substantial, that product should have been withdrawn from the market even
though it may have been a relatively safe product—that is, a product for which
the average risk posed by its consumers was relatively small.

The examples Priest offers of withdrawn products and services might be
expected to provide convincing evidence for his unravelling theory. In fact,
however, Priest's examples fit the internalizing theory very well, but are not
easily accounted for by the unravelling theory. As explained above, Priest
attributes the withdrawal of many consumer products and services to risk pool
unravelling and denies the possibility that it was because consumers were
no longer willing to pay for those products and services once their total costs
were internalized through higher market prices. It seems undeniable, however,
that most if not all of the products and services that he lists are particularly
dangerous relative to other goods and services. Perhaps Priest's position would
be more tenable had he provided examples of products that have been with-
drawn from the market and that were both reasonably safe—thus ruling out
the possibility they were withdrawn because of their danger—and used by
consumers fairly evenly across all income levels—thus corroborating the risk-
pool variance story.

284. Priest, Insurance Crisis, supra note 19, at 1566; see also R. COOTER & T. ULEN, supra note
1, at 373 (offering these product withdrawals as evidence of tort "crisis"); Epstein, Insurance Market, supra
note 1, at 648 (same).
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Moreover, the examples of withdrawn products and services that Priest provides subject the unravelling theory to an anomaly: according to the unravelling theory, low-risk manufacturer-insureds exited risk pools in response to increased premiums, because low-risk, not high-risk, manufacturer-insureds were on the wrong end of an insurance subsidy. Indeed, according to the unravelling theory, the higher the relative risk a given manufacturer posed, the greater the insurance subsidy that manufacturer enjoyed, and thus the longer that manufacturer would have desired to remain in its insurance pool, all else equal. Priest’s empirical examples, however, draw heavily on instances in which relatively high-risk products and services were withdrawn. The fact that relatively high-risk products were most affected by the changes in products liability is more readily explicable by the internalizing theory.

Consider the specific product and service examples Priest provides. Take first playground and swimming pool equipment. Priest does not discuss in specific terms how his consumer risk pool unravelling story explains the decrease in the number of park slides and diving boards. And, given that most injuries from those products probably occur to young children, it is hard to imagine that the lost-income component of damage awards could create sufficient variance in damage awards to generate unravelling. The more plausible explanation is that such equipment was withdrawn simply because it was very hazardous. Empirical evidence confirms that playground slides and swimming pools are extremely dangerous. Given that consumers and manufacturers had externalized many of the costs of product accidents under the old regime, it is no surprise that once prices rose to more accurately reflect the injury costs of this equipment, consumers (or municipalities purchasing on behalf of consumers) found they were no longer willing to pay market prices.

285. See also Priest, Insurance Crisis, supra note 19, at 1582 (“By my count, the industries that have been most seriously affected by the current insurance crisis are those dealing with hazardous materials, including toxic wastes, asbestos, and chemicals; manufacturers of pharmaceuticals and related products; hospitals, physicians in certain specialties such as obstetrics and anesthetics, and related practitioners such as nurse midwives; municipalities and other governmental entities; assorted general and machine manufacturers; general aircraft manufacturers; ski lift operators; day care centers; corporate directors and officers; liquor establishments; and publishers.”).

286. See Priest, Insurance Crisis, supra note 19, at 1522, 1552, 1570; see also Priest, Antitrust Suits, supra note 47, at 999.

287. There were 178,000 injuries from playground equipment and 124,000 from swimming pools, that required hospital emergency-room treatment. Of the eleven products listed by the U.S. Consumer Products Safety Commission, playground equipment and swimming pools were associated with the most injuries, together constituting 40% of all product-related injuries. See U.S. CONSUMER PROD. SAFETY COMM’N, U.S. PRODUCT-RELATED INJURIES: ANNUAL REPORTS (1983). It is little wonder that comedian Bill Cosby maintains that the placement of playground equipment on otherwise “perfectly good playgrounds” was part of a conspiracy by adults to “bump off” children, costing children arms, legs, and lives. Cosby’s survival technique as a child, he explains, was “never to play on nothing I never saw no grown-ups playing on.” Cosby, The Playground, from B. COSBY, WONDERFULNESS (Warner Bros. Records, 1970).

288. At times Priest lists municipal swimming pool and playground equipment as an example of products withdrawn due to expanded liability. But even setting aside the criticisms of the theory of unravelling risk pools made in Part II above, it is difficult to imagine how the unravelling theory could on its own terms begin to account for the withdrawal of municipal recreational equipment. First of all, it is not clear whether injured individuals recover from municipalities or manufacturers, and if the former, whether municipalities seek indemnification. Furthermore, it is not clear just what a low- or high-risk municipality would be. Finally, Priest uses the example even for self-insured municipalities, who presum-
For another example, consider the withdrawal of most intrauterine devices (IUDs) from the market.\textsuperscript{289} If the unravelling theory is correct, the withdrawal of IUDs was due to the unravelling of risk pools consisting of IUD purchasers. But it seems unlikely that there was much variance in the damage actually awarded given that many of the claimants litigated their claims through large class-action suits and thus received similarly sized awards.\textsuperscript{290} But even assuming there was significant variance in actual damage awards, it is difficult to imagine how the unravelling of that pool would proceed. It is not clear how low-risk and high-risk IUD users would know ex ante their respective positions in the risk pool. Even if they had this knowledge, it is unclear why high-risk users would remain in the pool, given the extent to which the losses associated with IUD injury are of a nonpecuniary and therefore non-compensable nature.\textsuperscript{291}

Moreover, a person’s choice of contraceptive is typically based, at least in part, on the recommendation or advice of a physician or health professional. Physicians, in effect, act as intermediaries between their patients and the market.\textsuperscript{292} Their recommendations are probably based primarily on risk considerations and only secondarily on price considerations. Thus, it seems unlikely that patients would adversely select or unravel in the market for contraceptives.

Besides being difficult to imagine, the unravelling theory’s explanation for the withdrawing of IUDs from the market gives short shrift to some of the alarming facts about IUDs.\textsuperscript{293} A.H. Robins’ Dalkon Shield, marketed from 1971 until 1974, injured tens of thousands of women. Responding to fears of a similar fate for its IUDs, G.D. Searle removed its devices from the market after several hundred claims had been filed against the company.\textsuperscript{294} Surely the withdrawal of consumer products of this kind is not obviously undesirable. It seems clear that relative to other contraceptives, IUDs are particularly

\textsuperscript{289} See, e.g., Priest, Insurance Crisis, supra note 19, at 1521 (refusal of liability insurers to provide coverage to manufacturers of IUDs “forced” them to withdraw IUDs from the market); id. at 1567 (liability costs prevent the IUD from being price-competitive with other contraceptives). The bulk of the IUD litigation has been directed at three IUD manufacturers: A.H. Robins & Co., which produced the “Dalkon Shield”; G.D. Searle & Co., which produced the “Copper-7” and “Tatum-7”; and Ortho Pharmaceutical Corp., which produced the “Lippes Loop.” A.H. Robins took the Dalkon Shield off the market in 1974, and in 1986 declared bankruptcy in the face of approximately 200,000 products liability suits. G.D. Searle & Co. took its IUDs off the U.S. market in 1986, having made approximately $80 million from sales of the Copper-7. Ortho Pharmaceutical has also taken its IUD off the U.S. market. Only one firm, Alza Corp., now markets an IUD—the “Progestasert”—in the U.S.

\textsuperscript{290} See Barrett, Over 25% of the Dalkon Shield Claimants Agree to Payments of $725 or Less, Wall St. J., Jan. 10, 1989, § 2, at 8.

\textsuperscript{291} See supra notes 138-42 and accompanying text.

\textsuperscript{292} See supra note 209.


\textsuperscript{294} See Searle’s Copper-7 IUD Loses Its Day in Court, NAT’L L.J., Sept. 26, 1988 (reporting 490 cases pending against G.D. Searle); IUD Discontinuation Seen as Unlikely to Affect Litigation, NAT’L L.J., Feb. 17, 1986 (reporting 300 cases pending against G.D. Searle and 450 settlements).
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dangerous. Priest recognizes the harm caused by the Dalkon Shield in particular, but nevertheless considers the withdrawal of IUDs in general to be an unfortunate result of changes in products liability law. But given that IUDs are quite dangerous and that less dangerous contraceptives are available, it seems unlikely that the withdrawal of several IUDs from the contraceptive market resulted in a net loss of consumer welfare.

Priest also emphasizes the withdrawal of certain vaccines. Given their benefits, the withdrawal of vaccines for whooping cough and polio appears at first glance to be a particularly unfortunate result of expanded liability, and hence a clear confirmation of Priest’s view. Apparently relying on the assumption that for any given consumer product, a consumer’s willingness to pay for that product depends on whether the benefits of its consumption outweigh the costs, Priest credibly concludes that because the social benefits of vaccines exceed the social costs, consumer unwillingness to buy them must have resulted from some inefficient source of interference with the market, namely, products liability. Accordingly, he argues that the withdrawal of vaccines must have been the result of enormous variance within consumer risk pools and the attendant unravelling such variance causes.

There is a simpler explanation for consumers’ unwillingness to purchase vaccines, however. Following the liability expansion, the benefits of some vaccines, from each individual consumer’s perspective, no longer outweighed their price. Once manufacturers and, in turn, consumers were made to internalize the full cost of a vaccine, including the costs of injury to those who developed a crippling disease as a result of taking that vaccine, consumers were less willing to pay the price. But that they were unwilling to pay the full price stems from the public-good nature of vaccines. Although the social benefits may well exceed the social costs of vaccines, the private costs may nevertheless exceed the private benefits. The benefit to any individual consumer of a vaccine is the reduced probability of acquiring the disease that the vaccine is intended to prevent. In an unvaccinated population, that reduction may be significant. In a vaccinated population, however, the reduced probability may be trivial. Thus, from the perspective of an individual in a vaccinated population, the private benefit of a vaccine may well not outweigh its full cost. The social benefits of vaccines are externalized. The removal of vaccines from the

295. The injuries resulting from the use of IUDs include, among others, pelvic inflammatory disease, perforation of the uterine wall, and ectopic pregnancy.
296. Priest, Insurance Crisis, supra note 19, at 1552.
297. See supra note 289. Huber also suggests that the withdrawal of IUDs was an unfortunate result of the expansion of manufacturer liability. P. HUBER, supra note 1, at 9, 41-42, 103-04, 141, 162.
298. Priest, Insurance Crisis, supra note 19, at 1521, 1569; see also P. HUBER, supra note 1, at 8, 11, 103-05, 182. Other scholars have also pointed to the withdrawal of vaccines. See, e.g., R. COOTER & T. ULEN, supra note 1, at 452-54; Huber, Safety and the Second Best: The Hazards of Public Risk Management in the Courts, 85 COLUM. L. REV. 278 (1985); Kitch, Vaccines and Product Liability: A Case of Contagious Litigation, REGULATION 11, 17-18 (May/June 1985).
market, therefore, may be less attributable to the increasing costs from tort liability and more attributable to the fact that consumers do not internalize the full benefits of consuming vaccines.300

With respect to consumer services, Priest offers obstetrics as an example of a service that was withdrawn from the market as a result of the liability expansion. Priest argues that “[t]he malpractice premium is extremely high for obstetricians because of the extraordinary variance that results from the attribution of subsequent physical or emotional ailments to problems of delivery.”301 But the unravelling theory does not easily explain that observation. First, obstetricians certainly know better the risks of medical complications and long-term emotional ailments than their patients do. Without such information, patients have no incentive to exit out of or adversely select into risk pools. Second, it seems doubtful that an obstetrician’s patients vary tremendously according to income. More likely, they come from a relatively homogenous subset of the population.302 And without high variance, there is nothing to precipitate unravelling. Third, and most important, because obstetricians deal with their patients face-to-face and routinely gather information about the risks facing their patients, obstetricians can, for the purpose of segregating patients into narrow risk pools, easily obtain more data than first-party insurers possess.

Another service the withdrawal of which Priest attributes to consumer risk pool unravelling is charter bus transportation to ski areas.303 But it seems clear that this service too would be likely consumed by a relatively homogeneous socio-economic group of consumers. The necessary condition for unravelling to occur—high variance of income among consumers—does not seem to be present with respect to buses chartered to ski resorts. Instead of unravelling, charter service to ski areas was likely withdrawn due to the high expected accident costs of the service, for buses are not at their safest on steep, tortuous, icy roads.

While the unravelling theory does not accommodate Priests’s product and service examples very well, the internalizing theory copes readily with each example. It predicts that the withdrawal of a product (or service) from the

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300. The solution to this public good “problem” is not to refuse compensation to the victims of vaccines. Instead, the solution is to either subsidize vaccine purchases so that consumers, no longer internalizing the full costs of vaccines, will more readily purchase them, or perhaps to subsidize the costs of compensation so that manufacturers will not have to charge consumers prices as high as real costs. Congress has done both. See, e.g., National Childhood Vaccine Injury Act of 1986, 42 U.S.C.A. §§ 300aa-1 to -34 (federal compensation program).
301. Priest, Insurance Crisis, supra note 19, at 1566.
302. In arguing that low-income consumers spend less on medical care than do high-income consumers, see supra note 130 and accompanying text, Priest corroborates this point. The observation about the extent to which product and service purchasers often constitute homogenous groups might be made with respect to Priest’s repeated invocation of wine tasting as an example of a service removed from the market as a result of expanded tort liability. See, e.g., Priest, Insurance Crisis, supra note 19, at 1521. It seems difficult to imagine a group of wine tasters so heterogeneous so as to precipitate unravelling.
market depended on the product’s relative danger measured in both pecuniary and nonpecuniary terms. Forcing manufacturers and, in turn, consumers to internalize expected accident costs created the deterrence benefits described in Part III above. Once nominal prices rose to reflect true costs, consumer demand levels shifted, and the market for some products simply disappeared. Playground equipment, diving boards, and IUDs—hardly run-of-the-mill consumer products—are examples of relatively dangerous products for which consumers were unwilling to pay prices reflecting true costs.

Perhaps it is because Priest can offer only a few examples of products that were withdrawn as a result of the “crisis,” and because the examples he does offer are of products that were unusually dangerous, that he makes the following argument:

The large number of products and services that have been totally withdrawn from markets demonstrate the severity of the effects of the contemporary tort law’s shift to the third-party insurance mechanism. Except for a few particularly notorious examples, product and service withdrawal tends to be effected silently, ignored as consumers shift to alternative sources that are higher priced or less convenient for their needs . . . .

Product and service withdrawal, however, has extended far beyond the limited examples reported in the press. Very recently, a Conference Board survey of the nation’s 500 largest corporations showed that twenty-five percent had removed products or services from the markets. . . . Consumers do not benefit from having fewer products and service choices . . . . Of course, it is even more difficult to estimate the extent to which new products and services were never introduced because of the expansion of liability. 304

Ironically, the evidence of the significant “silent” effects of the “crisis” provides little support for the unravelling explanation, but much support for the internalizing theory. The Conference Board report to which Priest refers concluded as follows: “Where product liability has had a notable impact—where it has most significantly affected management decision making—has been in the quality of products themselves. Managers say products have become safer, manufacturing procedures have been improved, and labels and use instructions have become more explicit.” 305 Almost one third of the manufacturers surveyed reported that products liability had led them to improve

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304. Priest, Insurance Crisis, supra note 19, at 1567-68 (footnote omitted); see also Priest, Antitrust Suits, supra note 47, at 999 n.2.
the safety design of their products. respondents were asked how much of the final price of their products can be attributed to the cost of liability insurance. for 66 percent of the firms, the answer was 1 percent or less. for another 11 percent of the companies, liability insurance accounted for only 2 or 3 percent of the final price. this evidence suggests that for most products the expansion of liability is having only a minor effect on prices, and for a significant number of products the expansion is having the beneficial deterrence effects that the alternative explanation predicts. that is, some dangerous products that had been marketed before the expansions of liability were made safer while others were withdrawn from the market altogether.

Moreover, it is unclear how the unravelling theory can explain the reluctance of manufacturers to introduce new products that they would have introduced had there been no expansion in liability. The internalizing theory suggests that after the expansion in liability, manufacturers would have a good reason to avoid introducing new products that are likely to be inefficiently dangerous. But Priest's theory does not explain how adverse selection and cycles of unravelling could possibly have occurred in consumer risk pools that, by definition, never even existed. Notwithstanding Priest's assertion to the contrary, it appears that consumers have benefited from having fewer products and fewer services on the market.

C. Exclusions and Copayment Mechanisms

Priest explains that following the expansion of manufacturer liability, there were changes in commercial insurers' policy terms, changes which included higher deductibles and higher levels of coinsurance. The purpose of those changes, he argues, was to mitigate the problem of adverse selection. He explains: "[D]eductibles and coinsurance narrow the level of risks brought to an insurance pool by discriminating against high-risk in favor of low-risk members of a pool." And "these changes reflect an effort to make the commercial policy more attractive to the relatively low-risk within provider pools."

306. Id.
307. Id.
308. Priest, Insurance Crisis, supra note 19, at 1570-76.
309. Id. at 1576. ("Each of these major changes in insurance availability, then, is a method to narrow insurance risk pools in the face of the increasing legal risk generated by modern tort law. Specifically, these contractual devices reduce variance in risk for the purpose of making insurance available to low-risk parties in the population of insureds. They are efforts to reduce adverse selection, and thus to prevent the unraveling of insurance markets that would occur if low-risk members of insurance pools were to exit."); id. at 1574 ("An insured that knows that its liability coverage will be reduced by the amount of the insurer's legal expenses may itself strive to reduce those expenses, by handling more case management tasks within the firm or, of course, by reducing the incidence of litigation-generating activity.").
310. Id. at 1572.
311. Id. at 1571.
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This explanation for the increase in coinsurance and deductibles seems incomplete. To understand how, it is useful to examine what Priest means by "high-risk" and "low-risk" members of a pool. Assuming first that all pool members have the same expected losses, "high-risk pool members" would be those who face a highly unlikely but large loss; and "low-risk pool members" would be those who face a relatively small but more probable loss. These definitions are consistent with the view that expanding liability law has increased the variance of risk faced by individual insureds. "High-risk pool members," in other words, would face a high variance in possible outcomes, whereas "low-risk pool members" would face a low variance. Yet, given these definitions, higher deductibles would benefit the high-risk pool members at the expense of the low-risk pool members, just the opposite of what the unraveling theory argues would happen. Low-risk insureds would be much more likely to file a claim than high-risk insureds would, and the size of the deductible relative to the size of those claims would be relatively large.

Perhaps by "high-risk" Priest instead means high expected losses, and by "low-risk," low expected losses—a different use of the word "risk." There probably is some variation in expected losses among the insureds of any given insurance pool. And Priest does argue that such variation increased as a consequence of expanding liability rules. But using this understanding of the term "risk" does not rescue the unravelling theory, because coinsurance and deductibles would not necessarily be disproportionately borne by "high-risk" insureds (that is, insureds with comparatively high expected losses). For example, suppose that insured A will ten times next year face a ten percent chance of losing $10,000. A, under this assumption, has expected losses of $10,000. Now suppose insured B will twice face a ten percent chance of losing $52,000. B, then, has expected losses of $10,400. Now suppose A and B, as co-members of the same insurance pool, are required by the terms of their policy to pay the first $2,000 of a claim as a deductible and ten percent of the balance of any claim as coinsurance. On whom does the heavier copayment burden fall? After paying the premium that all pool members pay, A expects to pay (because of deductibles and coinsurance) a total of $2,800 (i.e., $2,000 + $800). B, the insured with the higher expected losses, expects to pay only $1,400 (i.e., $1,000 + $400), half of what A expects to pay. In this example, the party with the higher expected losses expects to bear a significantly smaller amount and percentage of liability costs than the party with lower expected losses expects to bear.

Priest may instead be arguing that high-risk insureds are those with the greatest probability of making a claim. This would find support in the above

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312. Legal economists commonly employ these definitions. See A. Polinsky, supra note 226, at 79-81.
313. See, e.g., supra text accompanying note 146.
example in which insured A has the greater probability of making an insurance claim and expects to pay more in copayments. But this argument also has problems. First, the result in the example above is not generalizable. For instance, suppose that the deductible was eliminated and the coinsurance was raised to thirty percent. In that case, A would expect to pay $3,000; B would expect to pay $3,120. Therefore, the burden of copayments will not always fall more heavily on the insured with the greater probability of making a claim. Second, it is not clear how an insured's probability of making a claim (or claim frequency) is relevant to Priest's discussion of increased variance in expected costs, adverse selection, and unravelling.

These numerical examples reveal the incompleteness of the unravelling theory's explanation for the increase in coinsurance and deductibles. There is no reason to be confident that higher copayment requirements would be borne disproportionately by high-risk insureds. Moreover, Priest's description of precisely how insurers changed policies also does not clearly support his contention that the changes were adopted to control adverse selection. Instead, the rise in copayment requirement seems to support an alternative view, which Priest seems to agree with but never clearly expresses, that insurers adopted these changes to help control moral hazard. Priest writes:

Deductibles and coinsurance narrow the level of risks brought to an insurance pool by discriminating against high-risk in favor of low-risk members of a pool. The identical deductible will be less costly to an insured who can control the probability of loss than to an insured who cannot. The incentives created by deductibles and coinsurance transform those members who are relatively more able to control losses into low-risk insureds, and those members relatively less able, into high-risk insureds. Put slightly differently, the recent increases in deductible and coinsurance levels increase the effective insurance costs paid by high-risk members (because they must pay the premium plus the increased deductible or retention) while constraining the effective insurance costs paid by the low-risk members. They are a way to keep low-risk members in an insurance pool.

314. Alan Schwartz, for example, adopts this position. Schwartz, Proposals, supra note 10, at 405 (“Deductibles . . . reduce the adverse selection problem. A purchaser who agrees to a large deductible is telling her insurance company, in a credible way, that she believes she is unlikely to incur frequent losses. The insurance company then is more willing to insure her because it can plausibly believe she is a low risk.”).

315. According to Priest, the rise in copayments “reflects an effort by insurers to fight off modern tort law’s stimulus of adverse selection.” Priest, Insurance Crisis, supra note 19, at 1571.

316. Cf. Abraham, Environmental Liability, supra note 32, at 952 (arguing that the principal purpose of many exclusions is to combat moral hazard).

317. Priest, Insurance Crisis, supra note 19, at 1571-72.
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Priest, though he suggests here that insurers were segregating low-risk insureds from high-risk insureds, is actually describing how insurers were *transforming* some high-risk insureds into low-risk insureds. They did so by encouraging insureds to prevent preventable accidents. The same is true regarding the extensive exclusions that liability insurers have recently added to their policies.

Insurers would not have adopted those changes to help adverse selection. If adverse selection had been the problem, insurers would have sold policies with coverage exclusions for reduced premiums and policies without exclusions for higher premiums. High-risk insureds would have willingly paid the higher premium because of their greater exposure to risk. Low-risk insureds would have bought the less expensive insurance in keeping with their lower expected claims. In this way, then, insurers would have segregated insureds into appropriate risk pools (thereby effectively overcoming the asymmetric information problem) and maximized their sales and profits. But as Priest emphasizes—in his defense of liability insurers against allegations of antitrust violations—these exclusions were universal.318 High-risk insureds were entirely unable to obtain certain forms of insurance:

Excluding insurance coverage to provide lower premiums to low-risk members facing greater self-insurance alternatives is consistent with this aim [of segregating low-risk from high-risk members of commercial casualty pools]. But it is not consistent, indeed it is contradictory, to exclude coverage to the high-risk rather than to reprice these forms of coverage at greater than competitive levels. The ambition of price discrimination is to charge a greater than competitive price to consumers reflecting high price elasticities, such as high-risk insureds. The exclusion of pollution, occurrence, and defense cost coverage cannot be a means of illegally maximizing profits because no revenues can be generated where the insurance product is kept from the market. Again, excluding coverage is not a rational means of maximizing profits.319

Priest's defense of liability insurers poses a problem for his argument that policy exclusions were adopted in response to adverse selection. Just as excluding coverage would be an irrational means of maximizing profits, so would it be an irrational means of coping with adverse selection. For instance, insurers would forego profits if, in response to adverse selection, they totally excluded pollution coverage in all their policies. Instead, they could increase profits by offering two types of policies. One type would include pollution coverage at a price that would be acceptable only to high-risk insureds, and

318. Priest suggests that high-risk insureds could have obtained more insurance by paying more. See Priest, Antitrust Suits, supra note 47, at 1030, 1035. Ultimately, however, he denies that possibility by stressing that coverage for those sorts of risks was completely withdrawn from the market. Id. at 1038-39. 319. Id. at 1038-39.
the other type would exclude pollution coverage. Or similarly, some insurers would offer the former type of policy exclusively and other insurers would offer the latter. In either case, insurers would segregate low-risk and high-risk insureds and maximize both insurance coverage and insurance availability.\textsuperscript{320}

Thus, the more plausible explanation for why pollution coverage was eliminated in all policies is that moral hazard problems rendered insurance coverage unmarketable—that is, a large percentage of claims made under those policies could have been efficiently prevented. This raises a question: Why would insurers have not used the same devices before the crisis? The answer may well be that the old liability regime protected manufacturers from their own negligence.\textsuperscript{321} If manufacturers were often not held liable for accidents that they could have cost-justifiably prevented, then liability insurers would have suboptimal incentives to encourage their insureds to take optimal precautions. The reason for the increase in exclusions as manufacturer liability has expanded might well be that previous, less expansive liability rules did not, or were significantly less likely to, hold manufacturers liable for preventable accidents.\textsuperscript{322}

If a liability rule could provide optimal deterrence it would, by definition, hold manufacturers liable for all accidents that they could have cost-justifiably prevented at least cost. Similarly, if insurers and insureds could costlessly write and enforce fully specified contracts, they would not contract to cover liability costs that the insured could prevent. Ideally, then, insurance would exclude all preventable accidents from coverage and the tort system would hold injurers liable for all preventable accidents. But insurance policies, because of prohibitively high contracting and monitoring costs, are not fully specified. Instead, insurers and insureds contract to cover all liability except where the liability was obviously preventable—that is, where the liability very clearly resulted from the insured’s negligence.\textsuperscript{323} For instance, insurance policies

\textsuperscript{320}. Priest maintains that all insurers have adopted policy exclusions and limitations so that low-risk insureds would continue to demand insurance at the going rate. He sees this as consistent with the goal of maximizing insurance availability in society. He writes: “Few people would contest the importance of insurance in modern life. Indeed, few would dispute that a central ambition of a civilized society is to maximize the availability of insurance against all forms of prospective loss.” Priest, \textit{Antitrust Suits}, supra note 47, at 1000. But by adopting the goal of maximizing insurance “availability,” Priest does not fully consider another social goal of maximizing insurance coverage. If insurers raised coinsurance rates to 99%, they would lower the costs of insurance to all insureds and would attract extremely low-risk individuals who might otherwise go without insurance. But coverage would be extremely thin. Insureds would be left with very little insurance whatsoever. It appears that Priest would nevertheless endorse this result because it serves the social goal of maximizing insurance availability. In short, he does not consider the trade-off resulting from the fact that increasing copayment arrangements reduces insurance coverage though it may increase insurance availability. Attracting low-risk insureds at the expense of high-risk insureds may not be welfare maximizing.

\textsuperscript{321}. See supra notes 262-63 and accompanying text.

\textsuperscript{322}. Others have offered this explanation for why there continues to be negligent conduct in the face of what should in theory be optimal incentives under a negligence regime. See, \textit{e.g.}, S. Shavell, supra note 67, at 83-84; W. Landes & R. Posner, supra note 57, at 72-73.

\textsuperscript{323}. Put differently, the burden of proof required to shift the costs of an accident to a defendant-insured is significantly higher in the liability insurance context than it is in the tort context. A possible reason that insurers contract to cover almost all losses and not just negligently caused accidents is that they want to signal to manufacturers that in the event of a claim, the insurer will have the same incentive as
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commonly exclude coverage against insureds' intentional harms, and often exclude coverage against injuries caused by insureds' recklessness.\textsuperscript{324}

The recent increase in insurance contract exclusions, however, probably does not reflect a sudden increase in the obviousness of insureds' ability to prevent certain forms of liability. Although those forms that have been excluded do seem readily preventable, that fact was no less obvious to insurers before the crisis. It seems more plausible that the new exclusions have emerged because the previous regime did not hold manufacturers liable for as many preventable accidents as the current regime does.\textsuperscript{325} In other words, the most plausible explanation for the increase in copayment arrangements and exclusions seems to be that both the consumer product market and the previous products liability regime fell significantly short of optimizing deterrence.\textsuperscript{326} Manufacturers (and ultimately their liability insurers) were too rarely held

the insured when choosing whether to litigate or to settle. \textit{Cf.} G. EADS & P. REUTER, \textit{supra} note 145, at 134 n.27 (making this point with regard to punitive damages).

324. Standard-form comprehensive general liability policies usually provide that an insurer will not pay for those liabilities that the insured "intended" to incur. See Rynearson, \textit{Exclusion of Expected or Intended Personal Injury or Property Damage under the Occurrence Definition of the Standard Comprehensive General Liability Policy}, A.B.A. SEC. TORT & INS. PRACTICE, reprinted in \textit{THE COMPREHENSIVE GENERAL LIABILITY POLICY} 3, 3 (A. Liederman ed. 1985). For judicial interpretation of "intended," see City of Johnstown v. Bankers Standard Ins. Co., 877 F.2d 1146, 1150 (2d Cir. 1989) ("Recovery will be barred only if the insured intended the damages, or if it can be said that the damages were, in a broader sense, 'intended' by the insured because the insured knew that the damages would flow directly and immediately from its intentional act."); \textit{see also} R. KEETON & A. WIDISS, \textit{INSURANCE LAW} 493 (1988) ("[L]osses which are intentionally caused by an insured generally are not covered by liability insurance"); \textit{id.} at 492-93 (discussing exclusions based on reckless conduct or gross negligence). Priest emphasizes this point: "[I]nsurance markets cannot be sustained when there is substantial range for moral hazard. This is the reason that virtually all policies, including first-party policies, exclude coverage of intentional or reckless acts." Priest, \textit{Insurance Crisis}, supra \textit{note} 19, at 1583 n.244.

325. On one level, the liability insurance "crisis" provides evidence of how well third-party insurance works. Preventable accidents are precisely the kinds of accidents for which we want the manufacturer—not the insurer—to bear the losses. By lowering aggregate coverage, raising deductibles, and providing exclusions, third-party insurers are controlling moral hazard. Gary Schwartz has recently written:

There is a tendency for people to assume that for liability insurance to be unavailable signifies some breakdown in the overall functioning of the tort system. But such an assumption may well be misguided. The unavailability of insurance—far from revealing that the system is malfunctioning—may verify that it is functioning very effectively as a deterrence regime: that is, that it is targeting for liability precisely those forms of conduct that are so readily controllable by defendants as to render unacceptable to insurers the moral hazard prospect of insurance policies. Admittedly, I should be careful in not pushing this point too far. It is difficult to interpret the mid-1980s crisis in insurance availability as a consequence of moral-hazard considerations: for it is implausible that the prospect of moral hazard had become vastly more serious, in any general way, between 1980 and 1985. Nevertheless, at least selected aspects of the recent insurance crisis do not invite being interpreted along the lines of moral hazard. The refusal of insurance companies to write policies for [certain] torts . . . may well be due to insurers' assessments that [those torts] are so within the defendants' control as to render inadvisable a regime of insurance.

Gary Schwartz, \textit{Ethics and Economics of Tort Liability Insurance}, 75 \textit{CORNELL L. REV.} 313, 343-44 (1990). Schwartz is correct to suggest that recent exclusions were largely in response to moral hazard problems. He may be mistaken, however, not to pursue the argument further. For reasons explained below, it appears that the prospect of moral hazard \textit{did} suddenly "become vastly more serious" and \textit{did} lead to the "crisis" phenomenon.

326. Priest agrees that the previous negligence regime was ineffective from a deterrence standpoint. \textit{See} Priest, \textit{Accident Rate}, supra \textit{note} 47, at 221-22 (The old negligence standard "was crude and paid no careful attention to the determinants of the accident rate. There is little reason to believe that the negligence standard required even cost-effective investments by manufacturers. The adoption of the strict liability standard may very likely have improved accident prevention incentives."); \textit{see also} \textit{id.} at 202-07.
liable for the full costs of accidents that they could have prevented.\textsuperscript{27} If courts had held manufacturers liable for all of the accidents that manufacturers could have prevented, liability insurers, if they worked perfectly, would have disallowed coverage against such liability. That we now see new insurance exclusions for preventable liability suggests that the old negligence rule was not holding manufacturers liable for some preventable accidents, and consumers were absorbing the costs associated with manufacturers' inefficient behavior in the form of less than optimally safe products. Not surprisingly, incentives from the product market were not, by themselves, sufficient to force manufacturers to provide optimally safe products.\textsuperscript{328} In the absence of market-correcting tort law, consumers externalized the risk of nonpecuniary losses and externalized pecuniary costs to first-party insurers.\textsuperscript{329}

In his discussion of the effects of the “crisis” on day-care centers, for example, Priest recognizes that new exclusions serve deterrence goals, and thus he argues that courts should enforce such exclusions:

There is every reason that insurers should exclude coverage of [certain] claims, and that their exclusions should be enforceable. Sexual abuse of children is not the form of probabilistic loss for which the insurance function is appropriate. It is unclear, however, whether courts will find these exclusions enforceable in the compelling context of a suit by an abused child against a day-care center with low assets and an insurer with substantial assets where the motivating judicial objective is to maximize insurance coverage. The complete withdrawal of insurers from day-care coverage is strong evidence that judicial efforts to force coverage of uninsurable risks of this nature are short-sighted, reducing the effective insurance levels.\textsuperscript{330}

Even if it is agreed that courts should not force insurers to cover excluded losses,\textsuperscript{331} this does not support Priest's larger argument that courts should

\textsuperscript{27} Cf. P. Danzon, supra note 22, at 4 ("[T]he incidence of malpractice [in 1974 was] much higher than the frequency of malpractice claims."); id. at 24 ("At most 1 in 25 negligent injuries resulted in compensation through the malpractice system."); id. at 83.

\textsuperscript{28} Of course, if product markets were perfect, there would be no need for products liability laws of any kind. See supra notes 76, 249 & 263. See generally S. Croley & J. Hanson, Understanding Products Liability, supra note 1.

\textsuperscript{29} See supra Parts III(B)-(C).

\textsuperscript{30} Priest, Insurance Crisis, supra note 19 at 1572, n.198; see also Priest, Antitrust Suits, supra note 47, at 1043-44 (arguing that changes in insurance policies—such as "the pollution exclusion"—have beneficial deterrence effects).

\textsuperscript{31} As an aside, the authors do not accept the view that such contract exclusions should always be enforced. As a general matter, the authors would agree with Priest that courts should not force third-party insurers to pay for losses that are explicitly excluded from liability insurance policies. Presumably, the insurer and the insured have bargained over the terms of the insurance policy such that the risks are distributed efficiently between insurer and insured. In some instances, however, where a potential defendant is essentially judgment-proof—inasmuch as its potential liability losses exceed the value of its assets—it may be efficient to require the defendant to purchase (and insurers to provide) third-party insurance coverage for all losses. Day-care centers might be an example of a set of potential defendants who should be required to purchase liability insurance. Cf. Priest, Insurance Crisis, supra note 47, at 1572 (suggesting
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not hold day-care centers liable for all such losses. In fact, as already dis-
cussed, many of the exclusions in liability insurance policies are for prevent-
able losses. Even under Priest's proposed cost-benefit negligence regime,
manufacturers should be held liable for preventable losses. Policy exclusions
function to ensure such liability.

D. The Shift to Mutuals

1. The Unravelling Theory's Explanation for the Shift to Mutuals

As Priest observes, there has been a "tremendous increase in self-
insurance" "since the early 1970s." Because "[t]here [were] no general
accounts of the determinants of the shift from market insurance to self-
insurance," Priest offers his own. He argues that adverse selection causes
low-risk manufacturers to drop out of stock insurance pools and to form or join
mutuals or similar non-traditional stock companies such as "risk retention

possibility that day-care centers have "low assets"). Under such a rule, third-party insurance premiums
would be adjusted to internalize to the insured the cost of the insured's behavior. Also, requiring third-party
insurers to cover those losses, which they would otherwise exclude from coverage, would give the insurer
the incentive to monitor the behavior of the insured in this circumstance where the insured itself does not
have the appropriate incentives. Cf. Abraham, Environmental Liability, supra note 32, at 955 (explaining
that insurers can have "the same behavioral impact as regulation" over the insureds). Day-care centers
offer an excellent example of this phenomenon. Indeed, Priest's discussion suggests that third-party
insurers, who are being forced by courts to cover the insureds' preventable accidents, are intervening to
ensure that those losses will be prevented. "Day-care insurers reportedly now make unannounced inspec-
tions to monitor day-care centers' operations." Priest, Insurance Crisis, supra note 19, at 1572.

Of course, market forces might be sufficient to induce day-care centers to obtain full insurance if,
in fact, consumers demand it. Under the current legal regime, however, we would not see that demand
expressed insofar as insurers are already required to supply it, albeit against their apparent contractual will.
But even if the law were not as it is, consumers would find it difficult to express their demand for full
insurance. To see why, imagine a world where consumers prefer that their day-care centers be fully insured
and where courts permit day-care centers to obtain whatever level of insurance they desire. Under perfect
market conditions, day-care centers would all be fully insured. The market is imperfect, however, to the
extent that consumers cannot know which day-care centers, if any, are actually fully insured. If consumers
are asymmetrically uninformed, the profit-maximizing strategy for insureds is to obtain as little insurance
as possible but to signal that they have full insurance. If day-care centers can credibly and inexpensively
signal to consumers their true level of insurance, that asymmetric information obstacle will readily be
overcome. However, no such signaling device may be available. Consumers do not routinely make
investigations of a service-provider's insurance status and probably lack the expertise to evaluate the policies
and other relevant data. And the costs of acquiring such expertise probably exceed the benefits for
consumers. Day-care centers will not invest in educating consumers because it would be difficult to capture
the returns of such investments. In sum, it may be socially efficient for courts to disregard insurance policy
exclusions when the insurer could ensure the prevention of accidents through cost-justifiable premium
adjustments and/or monitoring and when the insured would otherwise externalize those costs through
bankruptcy and, hence, not prevent them.

332. See supra notes 321-24 and accompanying text. Again, a "preventable" accident is one that can
be prevented cost-justifiably.

333. The authors are grateful to Henry Hansmann for his helpful comments regarding this Section.
Throughout this Section, the term "mutuals" is used in a general sense to denote organizational arrange-
ments where owners and insureds are one and the same. In other words, "mutuals" is used as a convenient
synonym for "risk retention groups and the like." Strictly speaking, mutuals are one of three subspecies
of risk retention groups.

334. Priest, Antitrust Suits, supra note 47, at 1010. This dramatic shift may explain the vociferous
opposition of liability insurers to changes in tort law. Cf. id. (the shift reduces insurance industry profits).

335. Id.
groups” instead. Priest argues further that by exiting commercial insurance pools, low-risk members initiated unravelling, but he does not explain why the exodus of low-risk insureds from commercial liability pools was necessarily undesirable.

If it is true that by abandoning existing insurance pools low-risk insureds could obtain superior insurance for themselves, then the “unravelling” that ensued as a consequence of their leaving must have been efficient. Cross-subsidization within insurance pools is efficient on net only if the net benefits enjoyed by low-risk insureds exceed the allocational inefficiencies resulting from the cross-subsidy. If low-risk insureds can obtain those same benefits absent the cross-subsidy, efficiency considerations require that they do so. When low-risk insureds exit a given pool, the range of risks presented by the remaining members of that pool is narrowed. Or, put differently, the pool of remaining insureds contains a more homogeneous set of risks. And those who remain are charged premiums more proportional to the risks they pose. Consequently, there is less cross-subsidization among pool members.

Priest seems to assume that when insureds “unravel” from the pool they must either go entirely without insurance or else make do with some purportedly inferior form of insurance such as mutual insurance. Based on the observation that there has been a shift to mutuals, Priest claims that the total amount of insurance coverage enjoyed by manufacturers has been reduced. By implicitly assuming that mutual insurance is tantamount to no insurance, Priest can implicitly analogize the liability insurance market to Akerlof’s well-known “market for lemons.” That is, he can argue that low-risk insureds have the same problem that owners of high-quality used cars have in Akerlof’s model: there is no alternative market in which high-quality vehicles (low-risk insureds) can obtain a high-quality price (low-risk premium).

336. Id. at 1012. At present, there is little data on the size of the shift away from stock insurance toward new forms such as mutual insurance. It is widely believed, however, that the shift has been substantial and rapid. See P. DANZON, supra note 22, at 93; Sorry, Your Policy Is Canceled, N.Y. Times, Mar. 8, 1986, at 35, col. 3; Priest, Insurance Crisis, supra note 19, at 1570; see also G. EADS & P. REUTER, supra note 145, at x (“Our interviews suggest that the insurance industry is likely to play a declining role with respect to the large manufacturers that produce most of the consumer goods in the nation. The manufacturers have shifted largely to either self-insurance or policies involving high deductibles or significant coinsurance.”). See generally Priest, Antitrust Suits, supra note 47, at 1002-14 (documenting “the dramatic shift toward self-insurance that appears to have begun in the early 1970s”); id. at 1006-10 (reviewing evidence of “steadily increasing shift away from market insurance toward corporate self-insurance of expected liability exposure”); id. at 1009 (estimating that by 1986 at least 60% of all products-liability layouts were financed by self-insurance).


337. Priest claims that there has been a decrease in total insurance coverage, and he uses as evidence the reduction in stock insurance. Priest uses the phrases “the drying up of insurance” and “the disappearance of insurance,” Priest, Understanding the Crisis, supra note 47, at 196, and he claims that “between 1984 and 1986 the insurance capacity available to United States citizens for these types of injuries shrank dramatically,” suggesting that other forms of insurance besides commercial insurance do not constitute insurance. Id. at 197; see also Priest, Insurance Crisis, supra note 19, at 1539 (“[T]he modern regime somehow has led to the reduction of insurance availability.”).

338. Akerlof, supra note 117.
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But as the rest of this Section will argue, insureds exited stock insurance pools to join industry-wide mutuals simply because mutual insurance overcomes several potential problems inherent in stock insurance, problems that were heightened as a result of the recent changes in products liability law. Because of changes in products liability, mutuals have become the lowest-cost bearers of manufacturer risk in some industries.

Priest explains that high-risk insureds formed mutuals in response to changes in tort law. Although he does not explain their motivations, Priest seems to argue that, as a means of postponing inevitable bankruptcy, high-risk insureds withdrew from commercial casualty insurance pools to join mutual insurance pools wherein they could pay premiums ex post rather than ex ante. Priest writes:

High-risk mutuals . . . are formed as basically the last option prior to the termination of activity. . . . In my view, the recent increase in adoption of the mutual form derives from the different way mutuals diversify risks, and illustrates again how modern tort law has impaired the insurance function. . . . Industry-wide mutuals . . . aggregate risks, but in an ex post fashion. Mutuals wait for losses actually to occur and then set an effective premium to cover them. . . . [T]he chief difference between common stock and mutual insurance companies is that common stock companies charge premiums according to expected loss and mutuals according to actual loss . . . .

[A]doption of the mutual form allows firms to continue operation until judgments are rendered bankrupting the industry, instead of paying debilitating premiums ex ante equal to expected loss.339

There are several problems with this argument, however. One problem with the unravelling theory's treatment of the rise of mutuals is its suggestion that mutuals arise so that member firms can postpone their inevitable bankruptcies by paying the premium at the end of the insurance period rather than at the beginning. Priest seems to be arguing that mutuals are established to allow failing firms to play a timing game. But on the contrary, the members of mutuals pay premiums at the beginning of the period, not at the end.340 Moreover, the mutual insurance arrangements relevant to Priest's description are regulated, and there is no reason to think that regulation of mutuals is systematically different from regulation of stock companies. Thus, it is not clear why mutuals would charge any lower premium ex ante than their stock

340. It is not uncommon, however, for pool members to receive a refund at the end of the period if the period's claims do not exhaust the premiums. As explained below, the refunding of excess premiums to insureds gives mutuals an important efficiency advantage over stock insurers. See infra Part IV(D)(2)(e).
insurance counterparts would. Moreover, as an empirical matter, there is some evidence that members of mutuals pay roughly the same premiums as their stock-insurance counterparts do.

Even if members were required to supplement their premium during or at the end of the insurance period, it seems clear that under Priest's assumptions the mutuals—who would know that their member insureds are on the verge of bankruptcy—would make every effort to avoid underestimating the firms' liability costs. They would take little comfort in the fact that, if necessary, they could request more money ex post. Accepting the view that firms joining mutuals are firms at bankruptcy's door, the expectation would be that a mutual would require of such firms at least as high of a premium ex ante as a stock insurance company would. Thus, if a firm's goal is to avoid paying a premium at the beginning of the period, a mutual would be of no help.

Indeed, if, as Priest suggests, a firm's goal were to avoid paying liability claims until claims were made, the firm would have no reason to go to the effort and expense of forming or joining a mutual. Instead, it would go bare. In that case, the firm would be certain not to pay until after claims were made against it, and there would be some chance that bankruptcy would protect the firm from having to pay at all. Thus, although Priest concludes that the trend toward mutual insurance "illustrates how modern tort law has impaired the insurance function," his arguments do not clearly support his conclusion.

2. The Internalizing Theory's Explanation for the Shift to Mutuals

As Henry Hansmann has explained, the market tends to select the most efficient forms of ownership. This selection process will be most effective in industries where the barriers to entry of new forms of organization are low,

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341. Cf. R. KEETON & A. WIDISS, supra note 324, at 33-34 ("Historically mutual insurers often issued assessable policies, under which policy holders were subject to being assessed in the event the insurers did not have sufficient funds to pay claims. . . . [But] policies currently sold by mutuals usually are non-assessable. . . . The nonassessable arrangement is made possible by the fact that, before nonassessable insurers are licensed to operate in a particular state, they must meet, in general, the same financial requirements stipulated for stock insurers. Instead of having capital, however, the minimum surplus of nonassessable mutuals must equal the combined capital and surplus requirements of stock companies.").

342. P. DANZON, supra note 22, at 103 (medical mutuals often charged rates "comparable to those of stock companies they replaced").

343. Kevin M. Quinley, Vice President of Risk Services, Hamilton Resources Co., provided helpful information for this Section. Telephone interview with Kevin M. Quinley (Nov. 15, 1990) [hereinafter Quinley interview].

344. Hansmann, When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy, 99 YALE L.J. 1749, 1755-56 (1990) [hereinafter Hansmann, Worker Ownership]. According to Hansmann, efficiency will best be served if ownership is assigned so that total transaction costs for all patrons are minimized. This means minimizing the sum of both the costs of market contracting for those patrons who are not owners, and the costs of ownership for the class of patrons who are assigned ownership.

Hansmann, Ownership of the Firm, 4 J.L. ECON. & ORG. 267, 273 (1988) (footnote omitted) [hereinafter Hansmann, Ownership of the Firm].
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as they appear to be in the commercial liability insurance industry. According to the internalizing theory, changes in products liability altered the relationship between liability insurers and their insureds such that for some insureds mutuals became the most efficient form of insurance. To explain why firms moved from stock to mutual insurance, it will be useful to describe the primary difference between these two forms of liability insurance.

Broadly speaking, mutual insurers are owned as cooperatives by their policy holders. The insurers and the insureds are one and the same. The typical mutual risk pool is composed of a relatively small number of relatively homogeneous insureds, all of whom come from a single industry. Stock insurance companies, in contrast, are owned by investors in capital and usually cover many insureds representing many industries.

As explained below, because of these basic differences, the mutual form of liability insurance may have several advantages over the stock form. This is not to deny that the mutual form is without disadvantages. Indeed, if that were the case, then one would expect products liability insurance to have been always offered through the mutual form. This is simply to argue that, because of the changes in products liability, the advantages of mutuals now outweigh the disadvantages. Mutuals may be better able than stock insurance companies to cope with the problems of moral hazard and adverse selection. In addition, mutuals more easily cope with the problem of socio-legal uncertainty and imperfect contracts. Each of these advantages is considered in turn.

345 Priest, Antitrust Suits, supra note 47, at 1003-05.
346 Quinley interview, supra note 343. See Abraham, Environmental Liability supra note 32, at 948 n.21
347 One possible "advantage" that stock insurance might have over mutual insurance is that stock insurance diversifies across industries, whereas mutual insurance diversifies only across firms within an industry. This is true because stock insurers bring members of different industries together into a single insurance pool. Under mutual insurance, however, the industry-specific risk is not diversified because all members of the insurance pool are also members of the same industry. P. Danzon, supra note 22, at 86 (stating that joint-stock companies should be more efficient risk-bearers than mutuals). Therefore, firms of a given industry may not find mutual insurance as attractive as stock insurance insasmuch as the latter can help reduce the risk that is peculiar to the industry. However, even stock insurers are not always able to provide much diversification, see infra notes 366-71 and accompanying text, and thus firms may sacrifice little or none of that benefit by moving to the mutual form. G. Eads & P. Reuter, supra note 145, at 110-11, 132, 134-37. Because mutuals tend to have small numbers of insureds, they may have more trouble diversifying even firm-specific (i.e., non-industry-specific) risks. They may be less able, that is, to exploit the law of large numbers than they would be if they had more insureds. P. Danzon, supra note 22, at 89-90. However, the number of insureds need not be large for insurance pools to reap most of the benefits of the law of large numbers. For instance, studies of stock portfolios indicate that few stocks are required to obtain diversification roughly equivalent to the market as a whole. See, e.g., R. Brealey, An Introduction to Risk and Return From Common Stocks 115-31 (1969). Moreover, mutual insurers, like stock insurers, can diversify their pools further through reinsurance arrangements. See, e.g., G. Eads & P. Reuter, supra note 145, at 111. Reinsurance, in effect, brings the risks of several different pools together into a larger, more diversified pool. Through reinsurance, therefore, mutuals can diversify their industry-specific risk and can further diversify their firm-specific risk.

In sum, the comparative abilities of a stock insurer and a mutual to diversify risks is not clear and probably will vary depending on the industry. Even if it were universally true that stock insurance provided superior risk diversification, however, that would not imply that stock insurance would always be preferred to mutual insurance. As argued below, there is more at stake than risk diversification, and mutual insurance has efficiency advantages unrelated to risk diversification.
Because insurers cannot monitor insureds perfectly, insurance arrangements suffer from the problem of "moral hazard." Insurers cannot always know whether an insured is making relatively high levels or relatively low levels of efficient investments in avoiding liability. Insofar as insurers are uninformed in this respect, insureds have an incentive to invest suboptimally in avoiding liability irrespective of any contractual agreements to the contrary and of any premium discounts they enjoy as a result of such agreements. Consequently, insurers have an incentive not to offer premium discounts even for insureds who agree to contractual provisions mandating high levels of investment. That is, insurers will have no choice but to assume that all insureds will not make high-level investments in avoiding liability. This will be true even if insurers and insureds would both prefer a contract in which insureds received lower premiums and made greater investments in avoiding liability. The more difficult it is for insurers to monitor insureds, the more severe this moral hazard problem will be.

In general, one would expect mutuals to be superior to stock companies at reducing insurance losses that stem from moral hazard. As noted above, compared to stock insurers, mutuals insure a relatively small group of insureds. As the number of insureds in an insurance pool decreases, so does the gain from free-riding. In large insurance pools, for example, insureds will have a strong incentive to disregard their own liability costs inasmuch as those costs are spread evenly across the pool such that a given insured pays only a tiny fraction of them (i.e., \( z/n \), where \( z \) = the liability costs resulting from a given insured's decision to invest less than optimally in avoiding liability, and \( n \) = the number of insureds in the pool). As the number of insureds in a given pool decreases, however, the fraction of the additional cost ultimately paid by the insured increases (i.e., as \( n \) decreases, \( z/n \) increases). In other words, as the size of an insurance pool decreases, all else equal, so does the magnitude of the free-rider (or moral hazard) problem. In smaller pools, every insured bears a greater portion of the liability costs stemming from inefficient low levels of investment. This raises the cost of liability to any pool member and leads each pool member to invest a higher and more efficient amount in avoiding liability. Furthermore, because a mutual has only a small number of insureds and because, therefore, the costs that free riders impose on each of their fellow pool members are relatively high, the mutual form may encourage each insured to monitor her fellow pool members,

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348. See Akerlof, supra note 117 (providing classic statement of this phenomenon).
349. "[Mutuals] are typically small—to keep within bounds [each member/firm's] incentive to free-ride on the monitoring efforts of [the] other [members/firms]." Hansmann, The Organization of Insurance Companies: Mutual versus Stock, 1 J.L. ECON. & ORG. 125, 127 (1985) [hereinafter Hansmann, Organization of Insurance]. See generally Pauly, supra note 185.
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pressure her non-cooperating (free-riding) pool members to cooperate, and provide the insurer with techniques and information that might aid the insurer in selecting insureds for membership, in detecting free-riding pool members, and in adjusting premiums accordingly. The relatively small size of mutuals may reduce moral hazard, not only because the benefits of monitoring may be large, but also because the costs of monitoring the members of a small pool may be relatively low. Economists tend to believe that in arrangements that require cooperation, the average cost of monitoring increases as the number of parties to be monitored increases and likewise that the average cost decreases as the number decreases. This assumption is often made, for instance, in cartel theory and public-good theory.

In sum, because mutuals are composed of a relatively small number of insureds, mutuals both reduce the incentives for moral hazard and reduce the costs of monitoring. Mutual insurance may thus offer an important efficiency advantage over stock insurance, especially in contexts where monitoring insureds is important but difficult. Given that the moral hazard problem would probably have increased significantly in liability insurance pools following the inclusion of nonpecuniary losses accompanying the expansions of manufacturer liability, the shift to the mutual form of insurance is understandable.

b. Lower Information Costs

The potential insureds for any type of insurance are likely to vary in the degree of risk they present. Each potential insured may have more information than the insurer has about the degree of risk it poses. Indeed, it is this type of asymmetric information that Priest believes undercut the viability of the commercial liability insurance market. To some extent, Priest may be right. But as argued in Part III above, it seems doubtful that this led to harmful "unravelling." Instead, the shift of insureds out of stock insurance pools into mutual insurance pools appears to have occurred simply because the mutual form can cope with the problem of asymmetric information more effectively than stock insurance can. There are several reasons to believe that problems stemming from such asymmetric information—namely moral hazard and adverse selection—can be substantially overcome through mutual insurance mechanisms even though they might be fatal to stock insurance pools.

350. See, e.g., Ellickson, supra note 195, at 725 ("It will help to place the risk on the class of parties likely to have the lowest organization costs, usually the one with the fewest members.").
352. See supra note 160 and notes 183-86 and accompanying text.
Given that mutual insurance pools are composed of similarly sized members of a single industry, one would expect the variance in the degree of risk presented by pool members to be less in a mutual than in a stock company where pool members represent entities of various size from various industries. For many risks, insurers can provide more complete insurance and/or reduce the cost of insurance if they can assess the relative riskiness of prospective insureds through the application process, and if they can monitor the behavior of insureds who are part of the risk pool. An effective application process allows insurers to reduce adverse selection, and an effective monitoring mechanism permits insurers to discourage moral hazard and to suggest to insureds additional means of reducing risks. To have an effective application process, however, insurers need to know which of (and to what extent) an applicant’s characteristics will reflect its relative riskiness, and they must be able to verify the data that applicants furnish. Similarly, to monitor insureds effectively, insurers need to make close and frequent inspections of insureds, and they must be able to investigate and verify the claims that insureds make.

First, firms of a given industry organized as a mutual may, as an incident to their participation in and knowledge of the industry, often be better able than a stock company to create effective application and monitoring processes.\(^{354}\) Firms in the industry will have specialized knowledge about their industry in part because they have incentives, beyond a desire to minimize liability claims, to become informed about the industry.\(^{355}\) To succeed in their business, they are encouraged to garner information about every aspect and dimension of it. Moreover, as members of the industry, they have comparatively easy access to relevant information.\(^ {356}\) In other words, firms receive many benefits from becoming industry experts, and it is relatively inexpensive for them to do so. Stock insurers, in contrast, worry only about a few, general aspects of the many industries they must insure, because their interest is uni-dimensional and their access to information is relatively limited. Insurers do not already have

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354. Because they are composed of a single industry, mutuals may also have more specialized knowledge and better predictions of the products liability that is relevant to their industry than stock companies do. Cf. Epstein, Product Liability Reform, supra note 69, at 314 ("Products liability law is an extremely complex and diffuse body of law. An apricot with a pit inside is a product, but so too is a complex nuclear reactor. The type of reforms that will benefit some product manufacturers and sellers are often of no concern, or less concern, for others."). For those reasons, the mutual form may lower the administrative costs of processing claims, see supra notes 70 & 160 and accompanying text, and reduce socio-legal uncertainty.

355. Hansmann's description of mutual property and liability insurance companies in the 1800s supports this claim:

[H]ouse those firms within an industry that knew themselves to be unusually good risks [joined] together to form a mutual insurance company to insure themselves: the firms could recognize each other as good risks but would have difficulty convincing an insurance company from outside the industry that they deserve especially low premiums. Or, put differently, the cost of information about the riskiness of individual insureds was lower to firms within the industry than to those outside of it.

Hansmann, Organization of Insurance, supra note 349, at 146.

356. See Hanson & Logue, supra note 73, at 148-49.
all of the information necessary for successful monitoring, and, because they cannot benefit from the information in other ways, they have fewer incentives to acquire it.357 Not only do mutuals have lower information costs, but, for at least two reasons, mutuals may be more willing than stock insurance companies to invest in discovering ways in which their insureds could minimize the costs of liability.358

c. Overcoming the Problem of Inducement Costs

A stock insurance company will have a reduced incentive to invest in discovering efficient methods for preventing liability. This is true because in order to induce insureds to adopt this behavior insurers will have to pass some portion of the benefits of such discoveries on to their insureds through premium discounts.359 Otherwise, the insureds have no incentive to take the liability-reducing action. Consequently, stock insurers have suboptimal incentives to induce their insureds to adopt efficient practices.

It is because of the different forms of ownership that mutuals can overcome this problem while stock insurance companies cannot. In stock insurance companies, the stockholders are the residual claimants (that is, those to whom the net profits are distributed). Their collective interest conflicts with the insureds’ with regard to who receives how much of the gains from the insurer’s discovery. The more the insureds receive through discounted premiums, the less the shareholders will receive in dividends, and visa versa. With mutual insurance, in contrast, the residual claimants and the insureds are the same. There is no conflict of interest between insureds and insurers. Thus, if the mutual gives all of the benefits of the discovery to the insureds in the form of reduced premiums, that is tantamount to giving dividends to the mutual’s owners. Mutuals, then, have optimal incentives to invest in making these sorts of discoveries.

d. Overcoming the Problem of Asset Specificity

A second reason why mutuals may be more willing than stock insurance companies to invest in discovering ways in which their insureds could (and in encouraging insureds to) minimize the costs of liability stems from the fact that such investments are often asset specific. Once an insurer has invested in

357. Cf. G. EADS & P. REUTER, supra note 145, at x ("Several factors may explain the shift [away from stock insurance]. Differences in the incentives of insurers and insureds lead the latter to seek more control over decisions to litigate or settle. The flow of information may be better when the firm controls more of these activities."). See, e.g., id. at 134 ("The expertise developed in dealing with the regulatory agency also provides the basis for litigation expertise.").

358. Some of the theoretical points in this section are analogous to points made by Hansmann in his historical analysis of mutual property and liability insurance. See Hansmann, Organization of Insurance, supra note 349, at 129-48.

359. See Hanson & Logue, supra note 73, at 165-66.
determining how a particular firm could reduce its expected liability costs, the firm has an incentive to behave opportunistically by threatening to find insurance elsewhere unless the insurer lowers its rate to some level below what would be necessary for the insurer to recoup its sunk investments. Ex ante, therefore, stock insurers will be unwilling to make such research investments because they know they cannot recover the costs. This is true, in large part, because contracts in liability insurance need to be short-term contracts. Frequent changes in the law and other relevant variables make it necessary to renegotiate contracts at relatively short intervals. Because contracts are short-term, insureds would have the opportunity to defect after one contract period, leaving insurers unable to obtain sufficient returns to justify making the asset-specific investments in the first place.

Opportunism is mitigated under the mutual form first because each insured benefits by some amount when the mutual in general benefits, and, conversely, each insured suffers when the mutual suffers. Hence, insureds will have a reduced incentive to behave opportunistically because they themselves will have to absorb some of the costs of doing so. To be sure, even in a mutual, insureds will maintain some incentive to behave opportunistically. The point here is only that incentive will be less under the mutual form than it would be under common stock insurance. A second reason that insureds may have less incentive to behave opportunistically is that insureds in mutuals generally have no alternative mutual insurance pool that they can join. Industry-wide insurance mutuals often face comparatively little competition from other mutuals. If there are significant benefits to mutual insurance over stock insurance in a given industry, the threat of an insured in a mutual to leave and join a stock insurance pool is not, therefore, particularly credible. To leave the mutual, insureds would have to sacrifice the other benefits of the mutual form to shift to a stock company’s insurance pool. Even under short-term contracts, then, insureds have other incentives to stay with their mutual for the long term. Insureds in stock insurance pools, on the other hand, can make credible threats that they will leave their stock insurer for another, since there are other stock insurers on the market to whom the insured could turn.

360. Priest would probably not dispute the assumption that insurers must make significant asset-specific investments. See Priest, Antitrust Suits, supra note 47, at 1006 ("Much of the insurance coverage implicated in the antitrust suits and in the recent crisis consists of what is called special risk underwriting: the provision of insurance in a highly individualized manner to insured firms, with premiums set according to the particular characteristics of the insured firm itself.").


362. Because a mutual is owned by its insureds, pricing policies will reflect the fact that there is no conflict of interest between the insurer and the insureds. Even if a mutual had monopoly power, it would not exact monopoly rents from its insureds. See generally Hansmann, The Role of Nonprofit Enterprise, 89 Yale L.J. 835, 889-94 (1980).

363. See generally Priest, Antitrust Suits, supra note 47, at 1007-15 (noting that the commercial casualty industry is highly competitive, even within individual states).
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e. Coping with Socio-Legal Uncertainty and Imperfect Contracts

Many scholars emphasize the fact that the expectation of unpredictable changes in liability law makes an insurer's task difficult and risky. In the context of increasing socio-legal uncertainty, liability insurers try to estimate the expected liability costs of each of their insureds, but there is an increasing probability that the actual liability costs will vary considerably from their estimate. Although the individual risk terms may cancel out somewhat the more firms and industries there are represented in the insurance pool, if the liability standard becomes more strict "across the board," those risk terms will not cancel insofar as they move systematically. Insurers, therefore, are faced with significant risk. If they charge insureds according to their best estimate of what the standard of liability would be in the next period, the insurers, assuming their estimates have a normal distribution, would face a fifty percent chance of losing on all their contracts. And because their estimates could be wildly wrong, their losses could be enormous.

One solution to this problem would be for an insurer to recoup such losses by charging extra premiums in the future to those firms or industries on which the insurer lost money in the past. Over time the bad years would wash out with the good. The difficulty with such a strategy, however, is that the insurer can never recoup past losses in the current year, because if it tries to price over the competitive rate it will lose its insureds to other insurers who did not suffer losses in previous years or who recently entered the market in response to such above-competitive pricing. Ultimately, each insurer must view the previous year's losses as sunk costs and must concern itself only with the future and with covering its costs at the margin. Every insurer, that is, has no choice but to price competitively.

This all suggests that stock insurance companies face significant risks which they cannot fully diversify. In response to undiversifiable risk, stock insurers have had to add a "kicker" to the premium that they would otherwise have charged.

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364. This risk may well have been especially costly to stock insurers who could not rely on actuarial data to assess expected payouts, but had to set premiums according to individual judgments of liability costs. "Discovering that they were being charged 'judgment made' rates, firms evidently decided that they were as well (if not better) equipped than insurance companies to make these judgments and began to do so." G. EADS & P. REUTER, supra note 145, at 111.

365. TORT POLICY WORKING GROUP, 1986 REPORT, supra note 25, at 28 ("Insurers, like all profit maximizing companies, charge the price which maximizes their profits . . . . The argument that insurers are charging higher premiums to recoup past losses suggests that absent such losses their premiums would be lower—that is they would not be charging premiums that maximize their profits. That makes little sense."). Cf. P. DANZON, supra note 22, at 103 ([R]ecoupment of past losses is feasible only in a monopolistic or cartelized market with barriers to entry, and neither of these conditions characterizes the . . . [commercial liability insurance] market.). For evidence that the market for commercial liability insurance is highly competitive, see Priest, Antitrust Suits, supra note 47, at 1003-14.

366. This risk cannot be easily diversified through the stock market. See R. Winter, "Crises" In Competitive Insurance Markets (Working Paper in Economics E-86-74, Hoover Institution, Stanford University) (Dec. 1986) (showing that where there is a positive net opportunity cost to raising additional equity, diversification of insurers risk through the stock market will be incomplete); Danzon, Tort Reform, supra note 33, at 521.
charged based solely on their estimation of the expected liability of their insureds.\textsuperscript{367} The greater the uncertainty, the larger the kicker needs to be for an insurer to accept this risk. If insurers significantly underestimate the number and size of claims, the losses will be offset in part or in full by the extra premiums. Thus, the presence of socio-legal uncertainty may explain why insurers have charged more than their expected liability costs would suggest, and why insurers experienced higher profits on average during the height of the crisis.\textsuperscript{368}

Risks general to an industry that stock insurers cannot fully diversify, including socio-legal uncertainty, pose less of a problem to industry-wide mutuals.\textsuperscript{369} Firms may be relatively indifferent to increases in their liability costs so long as all firms in their industry bear the same costs. Mutual insurance becomes increasingly attractive as socio-legal certainty to an industry increase, because no matter the change next period in liability rules, consumers will be the ones to absorb much of the increase in costs through higher prices across the industry, and each firm will maintain its market share. Mutual insurance, unlike stock insurance, may provide an industry with a form of market-share insurance.\textsuperscript{370} This difference alone may give mutuals some advantage over stock companies, particularly for industries that face significant socio-legal risk.\textsuperscript{371}

\textsuperscript{367} P. Danzon, Second Look at Tort Reform, \textit{supra} note 33, at 10; see also \textit{supra} Part II(C)(4) (discussing Priest’s argument that premium increases have outstripped expected increases in claims).

\textsuperscript{368} See Winter, \textit{supra} note 39, at 457 (“The reconciliation of the increased profits of the industry over the period of the crisis and the larger magnitude of premium increases as compared to insurers’ costs is critical for the assessment of government policy . . . .”).

\textsuperscript{369} See Hansmann, \textit{Organization of Insurance, supra} note 349, at 148-49.

\textsuperscript{370} Id. This is not a case of firms simply increasing their prices in the future to cover past losses. After all, mutuals are formed in industries in which, by hypothesis, there is significant socio-legal risk. Because of their uncertainty over what their average liability will be in the next period, members of that industry mutual will not compete away this period what may turn out to be excess premiums next period. This will be true even in a competitive industry. Although socio-legal risk may appear to create above-normal profits ex post, there will be no entry because, from an ex ante perspective, manufacturers in the industry are merely being compensated for absorbing socio-legal risk.

\textsuperscript{371} Quinley interview, \textit{supra} note 343.

There may be several reasons why mutual insurance in this area came to be viewed as a viable alternative to stock insurance only fairly recently, after the expansions in liability.

(1) Following the increase in liability costs, the value of liability insurance increased, making it worthwhile to search for other means of insurance and also worthwhile to set up and run mutuals. Cf. Hansmann, \textit{Organization of Insurance, supra} note 349, at 126-27.

(2) The interests of manufacturers within any given industry coincided more closely following the increase in systematic risk than they were before it, because, by definition, systematic risk applies to everyone. Thus, the change in law made their interests more homogeneous. In addition, they designed risk pools to ensure that the interests were relatively homogeneous. See generally Hansmann, \textit{Ownership of the Firm, supra} note 344 (explaining why homogeneity of interests within a cooperative is important); Hansmann, \textit{Worker Ownership, supra} note 344 (providing evidence of the importance of homogeneous interests among joint owners); Hansmann, \textit{Organization of Insurance, supra} note 349, at 150 (mutuals in property and casualty insurance industry commonly insure in only one line of business because “costs of operating a cooperative increase dramatically when all the members are not purchasing the same thing from the firm and thus may have conflicting interests.”); see also Hansmann, \textit{Worker Ownership, supra} note 344, at 1796 (making similar point with regard to other types of cooperatives).

(3) Manufacturers may have left stock insurance pools to gain control over the decision to litigate or settle claims. See generally G. EADS & P. REUTER, \textit{supra} note 145, at 110-11 (offering three arguments for why manufacturers would have wanted to gain such control).
But probably the more important difference is that mutual insurance avoids the conflict of interest between policyholders and shareholders that may result from the tendency of insurers to add a kicker to insurance premiums in response to undiversifiable, socio-legal uncertainty.\textsuperscript{372} Mutuals do not suffer the contracting difficulties that stem from the problem of how to allocate the increased residual earnings that tend to accrue from the increased premiums.\textsuperscript{372} Hansmann has attributed an analogous advantage to mutual life insurance in the 19th century:

A mutual company can set a . . . premium rate that is high enough to provide reserves adequate for the most pessimistic forecasts . . . [T]hen, if and when events turn out better than a worst-case forecast, the excess reserves can be liquidated and returned to the policyholders as dividends. The difficulty of market contracting between companies and policyholders is eliminated simply by eliminating the market and replacing it with an ownership relationship.\textsuperscript{374}

In sum, the rise of mutuals appears to reflect not a crisis but rather an efficient response to a changing legal environment. This is not the first time the market selected for the mutual form of insurance over the stock form. Consider, for example, Hansmann's description of the rise of mutual property and liability insurance companies in the 19th century:

In order to understand the other factors that have given rise to mutual companies in the property and liability field, it is helpful to understand the circumstances of their origin . . . . . [T]he circumstances in which the successful mutuals arose were remarkably uniform. The stylized facts are roughly as follows: owners of firms within a particular industry and a particular region—say, cotton textile mills in Rhode Island . . .—who believed they presented unusually low risks of fire would find themselves paying fire insurance premiums to stock companies that they considered excessive. After trying unsuccessfully to persuade the stock companies to lower their fire insurance premiums, they would finally band together to form a mutual company to insure themselves. The resulting

\textsuperscript{372} Abraham calls this an "uncertainty tax." Abraham, \textit{Environmental Liability}, \textit{supra} note 32, at 958.

\textsuperscript{373} P. DANZON, \textit{supra} note 22, at 86 ("It should be little surprise that given the contracting problems that arose from stock insurance following the expansion of liability that mutuals have emerged and have "flourished."); id. ("bedpan mutuals," owned and controlled by physicians, "have flourished" and now write more than 40\% of premium volume nationwide); id. at 110 (the mutual avoids what would be costly contracting problems under stock insurance).

net premiums would be far below those charged by stock companies. Unlike the stock companies, the mutual would (1) insure only the better risks in the industry and (2) have a regular program of inspecting the firms they insured, both to assess the risk and to recommend loss prevention measures . . . .

Hansmann's description seems to be equally applicable to the more recent rise of mutual liability insurance companies.\(^{376}\)

**Conclusion**

The liability crisis seems to have been merely a phantom. The recent events now commonly associated with the "crisis" may be better understood as the inevitable and efficient consequences of desirable changes in products liability. The policy prescriptions voiced by members of the tort reform movement may therefore constitute an ill-considered and potentially harmful response to those events.

Part I of this Article presented the prevailing explanation for the increases in commercial liability insurance premiums and the withdrawal of some forms of coverage. That view attributes those increases to the high administrative cost of the tort system relative to first-party insurance schemes, the inefficiencies of nonpecuniary-loss damage awards, and the inability of product manufacturers to combat moral hazard. Part I offered three counter-arguments to the prevailing view. First, the total administrative costs of accident recovery through both the tort and first-party insurance systems may well be less under an enterprise liability regime than they would be under a cost-benefit negligence regime. Second, because nonpecuniary-loss damage awards are clearly desirable on deterrence grounds, the existence of such awards is consistent with efficiency goals. Third, manufacturer-provided insurance can and does employ mechanisms analogous to the deductibles and copayment mechanisms of first-party insurance.

Part II focused on the scholarship of Professor Priest. Whereas Part I analyzed that portion of Priest's scholarship that is common to the scholarship of virtually all members of the crisis movement, Part II scrutinized that portion of his scholarship that more clearly constitutes his original contribution to the crisis literature and upon which the other contributors to that literature commonly rely. Part II argued that Priest's explanation for how consumer and manufacturer risk pools have "unravelled" rests on unconvincing empirical and theoretical premises.

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\(^{375}\) Hansmann, *Organization of Insurance*, supra note 349, at 145.

\(^{376}\) One distinction is that in the 1800s the rise in mutuals was primarily among property insurers (e.g., fire), whereas the current rise in mutuals is among liability insurers.
What Liability Crisis?

Part III offered the “internalizing theory” as an alternative explanation for the crisis. According to the internalizing theory, recent events in consumer product markets are best explained not as the consequence of risk pool unraveling but rather as a result of the internalization of the nonpecuniary costs of product accidents, the internalization of the first-party insurance externality, increased socio-legal uncertainty, and the insurance market’s efficient response to those three developments.

Part IV compared this internalizing theory with Priest’s “unravelling theory” and argued that product withdrawal was best predicted not by risk pool variance but instead by product danger and the extent to which manufacturers and first-party insurers externalized the costs of product accidents. Part IV further argued that the increase in policy exclusions indicates not that insurers have attempted to segregate manufacturers, but rather that insurers have attempted to ensure that manufacturers prevent all preventable accidents. Finally, Part IV argued that the recent rise of mutual insurance reflects the market’s efficient response to increased problems of moral hazard and socio-legal uncertainty. According to the internalizing theory, phenomena such as the increase in insurance premiums and the withdrawal of certain goods and services from consumer markets are not undesirable. They are simply the consequences of the internalization of pre-expansion externalities, and they evidence the deterrence advantages of enterprise liability.

To be sure, other explanations for the liability “crisis” besides the prevailing unravelling theory have been offered (for example, insurance industry collusion). In contrast to those explanations, the internalizing theory accepts the widely held view that products liability is responsible for recent developments in the liability insurance markets. It concludes, however, that these developments evidence the success of the products liability revolution, not its failure.

By calling into doubt the prevailing view of the liability crisis, the goal of this Article has been to promote careful reconsideration of the liability reforms urged by members of the counter-revolutionary movement. Admittedly, the authors’ alternative explanation may contain its own shortcomings. But given the many criticisms now confronting the prevailing view, would-be reformers should rethink the arguments underlying their previously unchallenged policy prescriptions. Meanwhile, courts should move toward enterprise liability, unashamedly. On both deterrence and insurance grounds, enterprise liability appears to be the superior products liability regime. Moving closer toward enterprise liability, we should pause not to reconstruct the citadel, but only to commemorate its destruction.