LAW AND ECONOMICS

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Week 10

The level of damages
– The role of insurance

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Structure of the week

I.   Assessing the loss – calculating damages
II.   Judgment- proofness
III.   Punitive damages
IV.   Role of insurance

Legal definition of loss

- Reduction in the value of an asset
- Lost (expected) profit
- Mitigation cost

- Non-pecuniary loss – no damages (because no loss), but compensation
  – Why? Infringement of personal rights.
  – If no personal rights, no compensation for economic loss.
    • E.g. fear;
    • E.g. „emotional loss" – seeing fatal accident of a loved one;
    • E.g. birth of a child (failing contraceptive, failed abortion, non-disclosed information about a disease – in case of disclosure, abortion).

I. Assessing the loss

Pecuniary loss
- „Market value" = price (for a new one) – depreciation
  – Problem: how to calculate depreciation?
  – Problem: difference between market price and subjective value
- Historic cost (according to the balance sheet of company) = incoming value (historic price corrected by inflation) – depreciation
  – If there is no market, how to calculate depreciation?
- NPV of future income flow (annuity)
  – Correct in economic sense – but how to estimate future income?

Non-pecuniary loss
- Lost revenue: as if pecuniary loss;
- Lost expenditure (i.e. net revenue)? (e.g. NPV of income – consumption in future) => maybe negative (e.g. people with no income);
- Market behavior: what did he do to reduce the risk? (problem: false assessment of risk?)
- Hypothetical questions (conditional evaluation) – e.g. clear average, but realistic decisions.

Must be compensated?
- Basis of damages: externality – emotions are external costs
- BUT: accident reduces the marginal value of money – e.g. after accident, less utility can be bought by money
  – Maybe increase in marginal value of money (extra needs) – BUT empirical research: reduction is dominant effect

Unlikely, unforeseeable loss – need for compensation?

- Example: victim has a genetic bone disorder (Osteogenesis imperfecta or OI) – higher problem from the same accident.

- If unforeseeable, no incentive effect.
- Redistribution: victim will sue => administration cost

BUT:
- All unlikely (unforeseeable) events on average
- If high tail is omitted, average (*ex ante* expected damages) are reduced – weaker incentives (i.e. incentive effects EXIST).
  - Moreover: small damages – no suit (e.g. due to costs borne by the plaintiff) – average already too small (without reduction)
- Potential solution:
  - If limits on high tail, increase for small damages.
  - Everybody: „expected, average damages" – even if small loss.
  - Against the legal principle that prohibits gain from loss (c.f. potential moral hazard in economics)

**Pure economic loss – no damages in several countries.**
- Definition: no patrimonium, no health damage, no personal right
- Economic rational: loss = external effect
  - Example: *Richards v. Sun Oil Co.* Ship destroys single bridge to island
    - Rebuilding bridge = loss,
    - BUT lost profit in the restaurant, hotels on island?
    - NO: lost here, profit somewhere else – tourism somewhere else
  - Counter-example: water pollution => no fishing = loss.
  - Differences: deadweight loss – elasticity of demand and supply.
- Reduction in value of asset (loss in partimonium): capitalisation of all loss (others' loss)?
  - Example: *Torino Calcio SPA v. Romero*: injury of a football star
    - Reduction in income of player = loss,
    - But compensation for team?
  - Value for team likely capitalised in income – monopolised market (no close substitution of star), bargaining power advantage of star

Pure economic loss – special cases (Bussani, Palmer and Parisi):

- Ricochet loss: A destroys B's property, contract between B and C - impossibility
    - CAPITALIZATION, ELASTICITY
- Transferred loss: OK – price includes risk-taking: e.g. insurance.
- Closure of Public Property:
    - *Weller v. Foot & Mouth Disease Research Institute*: closed market - profit somewhere else
    - Petition of Kinsman Transit Co.: Brooklyn Battery Tunel – cable case (cutting cable creates black out in a large area)
        - No damages BUT there should be – main explanation: unforeseeability, and problems of assessment
- Professional advice
    - Lawyer: few potential victims – contract includes implicit guarantee (in the price)
    - Auditor: many potential victims – no damages, not in the price

II. Judgment-proof injurers

- What if loss exceeds assets of injurer: ($L = d > A$)
- Basic model: as if reduced damages due to judicial mistake.
- Weak incentive to take care.
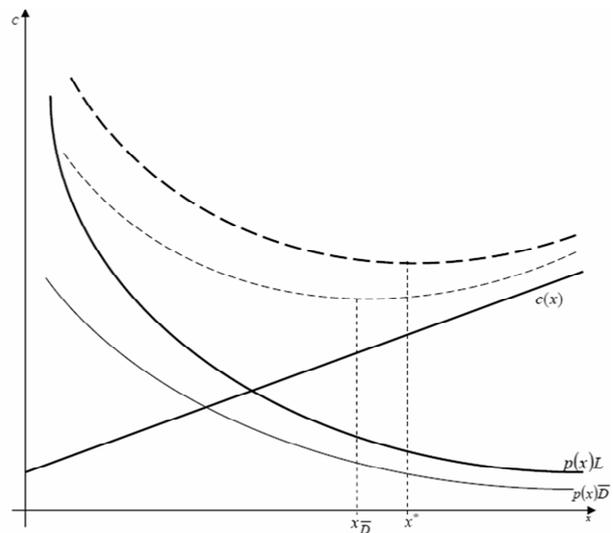
- Solution:
  - Vicarious liability – need for someone with an incentive (to control) + better risk-bearer (for judgment proofness???).

  If only damages – wait until harm or ex ante regulations?
  - Minimum capitalisation
  - Mandatory liability insurance
  - Regulation of activity (no damages in case of accident, but punishment if requirements are not fulfilled)
  - Criminal law: non-pecuniary sanctions

- BUT reduction in care – really?
  - Implicit assumption: risk-neutral actor – considers the expected loss of asset.
  - If risk-averse?
  - Two basic models:
    - Disappearing defendant (risk-neutral): assets higher than damages but cannot be reached
    - Small asset: real limit by asset – risk-aversion: supraoptimal care.

III. Punitive damages

Until now, implicit assumption: damages ($D = L$) for all accident
What if no (e: probability of no suit or decision for defendant, i.e. no damages)

    E.g. no defendant (disappearing defendant)

    E.g. no suit due to high cost – especially if small loss

Incentive for injurer: $x^* : w = p'(x)L$

                      $x^t : w = ep'(x)D$

optimum: $D = Lm$, where $m = \frac{1}{e}$

When?
- Intentional tort – direct utility from the victim's suffering of loss
- Small transaction cost – bargaining would have been possible (i.e. property vs. liability rules).
- Punishment as objective (other than deterrence; incentive – preference of society against criminals!).

IV. Role of insurance

Social objectives.
- incentives + risk allocation (compensation for victim)
- if trade-off: second best solutions
    – e.g. strict vs. negligence: risk-bearer test
    – e.g. partial damages (no full compensation for loss) if victim is better risk-taker.
- IF insurance: objective = incentive (only)
    – Strict liability: liability insurance?
        • i.e. victim does not need it – tort system provides implicit insurance.
    – Negligence
        • Victim needs insurance.
        • Maybe: injurer's insurance against judicial mistakes
        (e.g. if damages for loss cannot be reduced even by due care)

Liability insurance: Moral hazard?
- If not: full insurance + strict liability => social optimum.
- If it exists: incomplete, partial insurance (deductible, stop loss, etc.)
- BUT: if risk-averse injurer (and full damages) – better than no insurance
    – Victim gets full compensation (insurance does not harm him) AND
    – Injurer's risk is reduced.

Insurance of victim: insurance company as assignee
- Victim's insurance for what? Not for anything (i.e. moral hazard, adverse selection)
- Insurer – suit against injurer for its own part (pecuniary)
- Problem: neither insurer, nor victim gets all of the damages => weaker incentives to suit

Practice

Problem

A firm produces electronic parts, which sometimes fail. Since the damage is usually very small, nobody ever sues the firm.

However, a failure of one of its products once causes a very large harm: it creates a fire and a whole theatre burns down (the same failure normally leads to minor harm). There is evidence that the failing part caused the fire. However, the theatre demands larger damages than the loss that can proved.

In the course of the trial, experts prove that the firm employed the latest technology and a failure like the one that caused the fire cannot be fully prevented even by this technology.

What would be an efficient court judgement? Should the firm pay damages? Should the court accept the theatre's claim or make damages equal to the loss that can be proved? Why?

Solution

- Pros for strict liability
- Pros and cons of limitation based on unforeseeability
- Pros and cons of punitive damages

Revision

- What is loss?
- Reduction in the value of an asset (patrimonium), lost profit, mitigation cost

- Pecuniary
  – How to assess it?

- Non-pecuniary
  – How to assess it?

- Unforeseeability?

- Pure economic loss

Judgment-proofness

- Basic model
- Solutions
- Pros and cons?
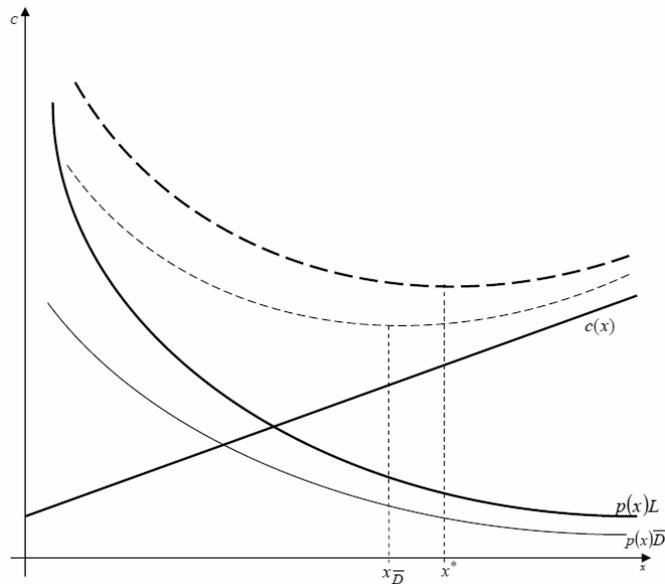
Discussion

When should liability insurance be mandatory?
- Small asset (compared to potential loss)
    – Potential loss transformed to prompt cost => optimal decision about level of activity!
    – Victim receives compensation.
    – Insurer's control – needed against moral hazard (i.e. suboptimal care)?
        - Disappearing defendant: yes
        - Small asset: no.
- If moral hazard – even worse
    – Level of care smaller than without insurance
        - Insurer would provide partial insurance if not mandatory.

Problem

In a country, most (but not all) health care institutions are financed by the government. According to the law, when a physician employed by such an institution makes a professional mistake (medical malpractice), the institution must pay compensation to the victim. In such a case, the court must consider whether the physician followed the protocol, i.e. the recommended medical procedure. The victim is entitled to damages only if the protocol was not properly followed.

Even if the institution is liable, the damages awarded do not fully compensate the victim. The reason for this is that, in practice, courts do not want to put too high a burden on the state health care system.

Evaluate the court practice.

Solution

- Incentives under negligence – medical malpractice: why not strict liability?
  - E.g. level of activity, substitution
- What if protocol is incorrect?
- Vicarious liability – why?
  - Control
  - Risk allocation
- Incentives in case of small damages
- Non-legal sanctions in health care

Revision

- Who is an owner in an economic sense?
- Who is the owner of a company…
  - …in the legal view?
  - …in the economic view?

- What are public goods? What is free riding?
  - Consumed by a group (no exclusion – even if one does not pay for it)
  - Results in free riding: consuming without paying.
- What is the problem of collective action?
  - Due to free riding, no public goods (or only in suboptimal quantity, quality).
- What is economic incidence?
  - Shifting a burden to someone else – different from legal incidence (who is obliged).
    - E.g. legal: on whom a tax is levied, who is punished by a fine, etc.
  - The cost is not always borne by those who are obliged by the law – but by those to whom the burden is *shifted.*