Alan Morse

Prof. Jeffrey Zax

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An Economic Critique of SB17-181

Under consideration this session is Senate Bill 17-181, which aims to restrict the collateral source rule in civil litigation in which a party has insurance. Currently in effect, the collateral source rule disallows evidence of insurance coverage that the plaintiff might possess from being presented to the jury. This bill would allow evidence of those collateral sources unless the plaintiff agreed to have the award reduced by the amount paid by the collateral sources or the amount paid in premiums by the plaintiff.

Proponents of SB17-181 rationalize the bill using logic that is often used by those in favor of greater tort reform. They contend that the collateral source rule, despite being highly regarded by the justice community since the early days of English common law, results in undesirable and unjust outcomes. (1) The collateral source rule allows for the plaintiff to recover damages twice, without need. (2) It provides a source of windfall for the plaintiff through claims of "phantom damages". (3) The result is an unacceptable misallocation of scare resources.

This analysis attempts to reconcile these claims with economic reality. The arguments for eliminating or restricting the collateral source rule seem reasonable enough. However, under the scrutiny of economics they fall short of a winning case.

Three counter-arguments will be presented in this analysis in favor of maintaining the collateral source rule as is. First, the collateral source rule ensures the plaintiff is compensated fairly both in the courtroom and in their insurance contract, which should remain mutually exclusive. Second, restricting the use of the collateral source rule results in an unfair wealth-transfer from the plaintiff to the tortfeasor. Lastly, this bill would exacerbate a negative externality of negligent conduct that the collateral source rule currently remedies.

Tort reformers like those in favor of SB17-181 often stress that the collateral source rule results in the plaintiff being overcompensated. In many cases, the plaintiff receives benefits in the form of collateral from insurance companies and then again in damages received from the defendant. They believe this to be unfair.

This logic fails to see that there are two transactions occurring independent of one another. The compensation the plaintiff receives from the insurer is the result of a private contract negotiated prior to the incident at hand. The insured agrees to pay for a policy and a reoccurring premium in return for collateral against uncertainty. In addition, the insured incurs an opportunity cost from setting aside funds overtime for coverage forgoing other resources or possible interest (Marshal and Fitzgerald 2005).

When these economic and opportunity costs are taken into account, it can hardly be considered a windfall for the plaintiff. Instead, it is the “expected remittance purchased by a risk adverse wagerer” (Marshal and Fitzgerald 2005). Richard Posner, Judge of the U.S. Court of Appeals for the Seventh Circuit, defends the collateral source rule noting, “the claimant buys the insurance policy at a price equal to the expected cost of the policy plus the cost of writing the policy” (2003). A plaintiff that obtains compensation from insurance is merely getting what they already paid for under their contract.

The notion that a plaintiff recovers damages twice is indeed an economic falsehood. It is reasonable for a plaintiff to expect a return on his or her insurance contract separate of any negotiations settled inside the courtroom. Allowing the collateral the plaintiff receives to be considered by a jury actually threatens the possibility of the plaintiff being undercompensated.

The plaintiff is likely to see compensation below the total cost incurred from the insurance policy, opportunities forgone, and the damages incurred from the accident. Furthermore, the insurer is inclined to reclaim an additional amount of the benefit from the plaintiff through heightened future premiums. In this case, the plaintiff shares an unfair burden of the cost from the accident where he or she should be the beneficiary.

This contradicts the claim that the collateral source rule results in a misallocation of resources. The rule actually helps to ensure that all parties pay the plaintiff their fair share. In fact, it is restrictions on the collateral source rule that risk allocating resources in the courtroom inefficiently.

The expected outcome of eliminating the collateral source rule is a wealth-transfer from the plaintiff to the defendant. If the plaintiff is unable to recover damages because of their insurance benefits, the tortfeasor pays nothing, and takes all the benefit of the insurance policy (Marshall and Fitzgerald 2005). This happens despite the tortfeasor not paying the premium. Since the victim is the one who has paid, it would be unfair to allow the tortfeasor to recoup the benefit (Kidd and Krauss 2009).

It is easy to see the irony of this situation. Marshall and Fitzgerald note, “only in the absence of the collateral source rule does a windfall inure and it inures to the benefit of the negligent defendant.” (2005). The defendant reaps an unearned discount on damages to be paid at the expense of the victim.

In essence, the plaintiff subsidizes the damages to be paid by the defendant through their own insurance policy. All or some of the economic incidence of the accident falls on the victim. This is simple redistribution.

The resulting wealth transfer creates perverse incentives for the negligent defendant. Eliminating the collateral source rule will increase the incentive to victimize those who are likely to be better insured. The cost of victimizing these people is lower and the potential windfall (or discount) is higher. This bill will make well-insured and wealthier people relatively more vulnerable.

The collateral source rule is essential to protect vulnerable populations and to combat negative externalities associated with negligent misconduct. Without it, socially optimal outcomes are harder to reach in civil litigation. The court produces microeconomic equilibrium more efficiently when the collateral source rule is applied.

It forces all parties involved to internalize the economic costs of their actions. Christian Saine of Case Western Law Review explains, "The traditional collateral source rule correctly places the monetary liability for damages caused due to wrongful behavior on the injuring party" (1997). A defendant knows that the cost of negligible misconduct is equal to the damages inflicted on the plaintiff. As a rational actor, the defendant is less likely to engage in misconduct where the cost in damages is high. This expected price is a useful deterrent against the negative externality on society.

Without the collateral source rule, the incidence of cost does not always fall on the party responsible for damages. The price a defendant will expect to pay for their actions is reduced. At the margin, they will engage in more misconduct to whatever extent they are not required to compensate their victim (Marshall and Fitzgerald 2005).

This exacerbates the negative externality felt by society. When the defendant is not required to internalize the cost of their negligent act, society suffers the consequences. Holding dangerous drivers less responsible for their actions, for example, only encourages more reckless tendencies behind the wheel.

It is necessary then that the magnitude of cost be assessed on the tortfeasor and not on other parties. Doing so ensures that they personally feel the cost of the externality they created (Marshall and Fitzgerald 2005). Neither the insurance company, nor the plaintiff, should be held responsible for the actions of the tortfeasor. The externality is not remedied efficiently when the cost is diluted across parties.

The Colorado State Assembly should consider the legal and economic merits of maintaining the collateral source rule as is. It is a vital tool in civil litigation to ensure fair outcomes are reached. Plaintiffs are only fairly compensated for all their costs when the contract with their insurer and their transaction with the defendant are treated separately.

The General Assembly should protect the collateral source rule and vote no on SB17-181. Without the collateral source rule, a windfall is not bestowed on the plaintiff, but on the defendant. Redistribution of wealth to the tortfeasor results in a disequilibrium and a failure of the court to allocate damages to their responsible parties. Society looks to bear the negative externalities from an increase in negligent misconduct not properly deterred by civil litigation.

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