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## *policy brief*

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## The Uneasy Case for Product Liability

By A. Mitchell Polinsky and Steven Shavell

*The benefits of product liability appear to be outweighed by its costs. First, product liability has not been found to have improved product safety in a significant way. This may be because firms have reasons to enhance product safety even in the absence of product liability: Their sales are likely to fall if they harm consumers, and they are often subject to safety regulation. Second, product liability does not substantially promote desirable compensation, especially because accident victims already often receive compensation from their insurers. Product liability is, however, very costly. Consequently, we conclude that the case for product liability is not strong, particularly for widely sold products, with respect to which market forces and regulation are relatively effective.*

Tens of thousands of product liability cases are filed annually in state and federal courts, including some as class actions that involve hundreds of thousands or even millions of individuals as plaintiffs. Moreover, product liability is of growing importance outside of the United States, particularly in the European Union and in Asia.

Perhaps surprisingly, no one has attempted to

investigate whether product liability as a whole is socially desirable, considering its major benefits and costs. In an article forthcoming in the *Harvard Law Review*, upon which this policy brief is based, we undertake that task and come to the judgment that product liability may be socially undesirable in a broad range of

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circumstances.<sup>1</sup> The essence of our argument is that the two major beneficial effects of product liability — inducing firms to improve product safety and providing compensation to injured consumers — are likely to be outweighed by the costs of resolving product liability cases. (In our longer article, we also discuss the effect of product liability on product prices.)

## **The Safety Benefit of Product Liability**

The potential safety benefit of product liability is limited, for two basic reasons. First, even in the absence of product liability, firms have an important market-related motive to manufacture safe products. Namely, their sales will tend to fall if their products harm consumers or are viewed as unduly risky. For example, Tylenol's market share fell from 37 percent to 7 percent in 1982 following the deaths of seven individuals who had ingested Tylenol capsules contaminated with cyanide. Similarly, Odwalla's sales of natural juices declined by 90 percent in 1996 after one person died and 60 were made ill from consuming some of its products

containing E. coli bacteria. And Audi's sales dropped by 69 percent after reports in the mid-1980s of problems of sudden acceleration in its vehicles.

Second, safety regulation mandates that firms reduce the risks of injury associated with a broad range of products. Automobile safety regulations enforced by the National Highway Traffic Safety Administration contain many requirements pertaining, for example, to seatbelts, crashworthiness, fuel tank construction, and windshield and tire strength. Pharmaceutical products must satisfy rigorous testing and labeling requirements that are overseen by the Food and Drug Administration. Stringent aircraft safety standards, set by the Federal Aviation Administration, govern the manufacture, maintenance, and airworthiness of all aircraft. Safety standards developed and enforced by the Consumer Product Safety Commission apply to numerous consumer products, such as toys, cigarette lighters, baby cribs, and household chemicals.

Against this background of market forces and regulation,

one might question whether product liability would exert a significant additional influence on product safety, and our conclusion is that it is not likely to do so. This view is based on consideration of the available empirical research on the effect of product liability on product safety. Notably, George Priest examined general accident statistics during the 1970s and 1980s, a period when the scope of product liability law grew significantly and the volume of product liability litigation greatly increased, but he found no discernable effect of the enhanced product liability activity on accident rates. Other researchers studied specific industries or products — general aviation aircraft, motor vehicles, and the DPT vaccine — and also failed to find any effect of heightened product liability litigation on safety.

Although this evidence comprises a relatively limited literature, it is essentially uniform in its conclusions and suggests that product liability has had little or no influence on product safety. We surmise that the explanation is that market forces and regulation

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1 See A. Mitchell Polinsky and Steven Shavell, "The Uneasy Case for Product Liability," *Harvard Law Review*, forthcoming. A pre-publication version of this article is available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1468562](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1468562). We do not include in this policy brief support for the claims we make, which is provided in the longer version.



already generate substantial safety investments by firms.

### **The Compensation Benefit of Product Liability**

The potential compensation benefit of product liability is the provision of implicit insurance — in the form of settlements or court awards — to risk-averse victims of product accidents. But product liability promotes compensation of accident victims only incrementally, because individuals already have extensive insurance coverage (including through public compensation programs). In other words, individuals frequently would be compensated for some or all of their product-related losses even in the absence of the product liability system.

This is not to deny that product liability provides compensation beyond that available through insurance. However, there are several factors that limit the compensatory benefit it yields to injured parties. Notably, so-called subrogation provisions in victims' insurance contracts give insurers the right to retain from any settlements or awards to victims an amount up to what the insurers had paid the victims under the terms of their insurance policies.

Additionally, if product liability does result in an accident victim obtaining

compensation beyond that available through insurance, the utility of this compensation will be relatively low. The reason is that the victim's insurance payments will be used to satisfy his most pressing financial needs (say for payment of medical expenses). The further payment he obtains through the product liability system will be used to meet his remaining and less important needs.

Legal fees also limit the compensatory benefit of product liability. The great majority of product liability suits are brought under contingency fee arrangements, in which individual plaintiffs typically have to pay 25 percent to 33 percent of the amount received to their lawyers. The legal fees of class action plaintiffs average approximately 18 percent of the value of settlements or awards.

Finally, product liability actually tends to work counter to the compensation goal because it awards accident victims compensation for pain and suffering, a nonpecuniary loss. Such compensation tends to be of low value because pain and suffering per se usually does not increase one's need for money, however much it lowers one's well-being. For example, although the death of a child would cause the child's parents the greatest anguish, this loss would not

be likely to generate a greater need for money (it probably would decrease their financial requirements). When one takes the cost of providing compensation for pain and suffering into account — product prices will rise to cover manufacturers' payments for pain and suffering damages — consumer welfare will decline.

### **The Costs of Product Liability**

Studies of the cost of the liability system demonstrate that for every dollar that victims of accidents receive through the liability system as settlements or court awards, average legal expenses incurred are about a dollar. In other words, for society to use the liability system to transfer money to accident victims is analogous to using an ATM machine at which a withdrawal of \$100 results in a service fee of approximately \$100.

Actually, there is a sense in which the liability system is even more expensive than this. For every \$100 nominally received by accident victims, only a fraction of this amount is retained by them on average because some of it is kept by their insurers under the subrogation arrangements that we mentioned above. If, for example, victims retain \$50 of each \$100 received, society incurs \$100 in

legal expenses in order to transfer only \$50 to victims. Equivalently, for each dollar received by an accident victim, two dollars of legal expenses are incurred. In all then, the liability system, including product liability, is extremely expensive.

### **Is Product Liability Socially Worthwhile Given Its Benefits and Costs?**

To summarize, product liability yields no measurable product safety benefits and limited (or even welfare-lowering) compensatory benefits, but its costs are substantial, equaling or exceeding the payments received by victims of product accidents. Our conclusion, therefore, is that the case for product liability is problematic. This conclusion is especially applicable to widely sold products, such as drugs and automobiles, because the influence of market forces and regulation on product safety tends to be stronger for products that are sold in high volume.

### **The Prevailing Judicial Endorsement of Product Liability**

Our critical assessment of product liability contrasts with the widespread, though not universal, endorsement of product liability in judicial opinions. The broadly

favorable view of product liability held by the judiciary derives from the fact that product liability appears to satisfy basic notions of fairness and to yield significant product safety and compensation benefits. But this opinion is essentially conclusory: It does not recognize that the benefits of product liability are incremental in nature (only the enhancement to the level of product safety already generated by market forces and regulation, and only the addition to the level of compensation already yielded by insurance coverage, should be counted). Furthermore, the proponents of product liability generally ignore the high litigation costs that it generates.

The influential opinion of California Supreme Court Justice Roger Traynor in *Escola v. Coca-Cola Bottling Co.*, concerning harm done by a defective Coca-Cola bottle, is illustrative of judicial reasoning. In the opinion, Justice Traynor states the following: “[P]ublic policy demands that responsibility be fixed wherever it will most effectively reduce the hazards to life and health inherent in defective products that reach the market. It is evident that the manufacturer can anticipate some hazards and guard against the recurrence of

others, as the public cannot.”

This is essentially the only language in *Escola* that mentions the effect of product liability on product safety, and its logic is problematic. It is true that manufacturers may be able to reduce risk and consumers unable to do so, but this does not imply that *liability* is needed to induce manufacturers to lower risk. As we have observed, even in the absence of liability, manufacturers would not want to market dangerous products if their sales would fall in the wake of product-caused accidents, and safety regulation might also cause manufacturers to reduce risk.

Concerning compensation, Justice Traynor states that “[t]he cost of an injury and the loss of time or health may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the manufacturer... .” Yet Justice Traynor does not recognize that many individuals already possess insurance, substantially lessening their need for compensation through the product liability system. He thus also does not recognize that subrogation provisions in insurance policies imply that a significant portion of liability payments made

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by defendants are in fact channeled to insurers rather than to accident victims.

Justice Traynor also fails to discuss the costs of the product liability system. Therefore, it is not surprising that his view, which is representative of judicial thinking, is that product liability is socially desirable.

### **Conclusion**

If our analysis of product liability is accepted, it implies that such liability should be substantially curtailed. This could be accomplished

by having courts take into account several factors that bear on the desirability of product liability, namely whether consumers are well informed about the product's risks, whether regulators adequately control the safety of the product, and whether consumers have appropriate insurance coverage against the harm in question.

Even the elimination of product liability could be contemplated. Such a step would not be as radical as might first appear. Accident liability for personal injury

was abolished in New Zealand in the 1970s, and accident liability has been displaced in this country in significant domains: Liability for workplace injuries was terminated in the early 1900s when workers' compensation legislation was enacted, and liability for automobile accidents was replaced in the 1970s in many states by no-fault regimes. Thus, ending product liability for widely sold products, though admittedly a dramatic step, would not be without precedent.

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