

A Suggested Role For Collateral Sources Of Indemnification In Tort Reform Legislation

By Manfred H. Ledford, Ph.D.

TORT REFORM HAS RECENTLY BEEN ADDED to the national agenda by President Bush as evidenced by his commitment to raising and discussing the issue in his 2004 re-election campaign. The focus of the discussion, both in the Presidential and Vice-Presidential debates during the fall of 2004, as well as on the stump, was caps on awards for non-economic damages (e.g., pain and suffering, loss of consortium, etc.). The clear purpose of instituting caps is to reduce the financial exposure of business and government entities in potentially large liability claims and, therefore, to reduce general operating expenditures through either the expected concomitant reduction in liability insurance premiums or directly through reduced exposure to retained liability risks and, consequently, making the American economy more competitive in the international arena. The same logic applies to liability insurance premiums for individuals since the less they spend for a given quantity of any economic good, the more of their disposable income there is available for either spending on other economic goods or to devote to saving.

While the debate regarding the limitation of compensation for non-economic damages and implementation of caps is not entirely new (e.g., current caps on pain and suffering awards in medical malpractice actions in California), it does, by the very nature of the issue, tend to be conducted on a subjective level. After all, the emotional feeling of a trier of fact in favor of a plaintiff and against an alleged tortfeasor, or vice versa, most probably controls the reasoning which leads to a decision regarding the amount of an award for general damages. This is

clearly a subjective exercise on the part of triers of fact.

There is another issue in liability tort cases that, being more objective in nature, should be considered in the tort reform discussion. This is the treatment of collateral sources as offsets for awards of special damages.¹ Collateral sources are payments received by or payable to injured, or allegedly injured, parties in tort actions from third parties that mitigate economic

damages claimed by them. Examples of collateral sources in personal injury/wrongful death litigation are income disability insurance policy payments, life insurance proceeds, medical expense and wage loss benefits in personal auto policies under Personal Injury Protection coverage, wage continuation benefits, and workers' compensation benefits. There are others.

Nearly half of the 50 states have legislated provisions as part of their respective wrongful death and/or personal injury statutes that allow consideration of at least some types of payments by third party payers to be used as offsets to court awards for special damages in personal injury and wrongful death cases. These provisions are generally referred to as 'collateral source

rules.' The sources of payments, past and legally obligated in the future, that are allowed or specifically prohibited by these various statutory provisions reflect no consensus. While most collateral source rules do not allow the trier of fact to consider sources of government transfer payments such as Medicare and Medicaid benefits or benefits paid or payable by third parties that have a legal or mandatory right of subrogation, such as Workers' Compensation payments, the other sources of payments that are excluded from consideration by triers of fact vary



dramatically amongst those states that have enacted collateral source rules. Also, some statutes restrict the use of collateral payments as offsets to damage awards only in certain types of actions.³

One commonly excluded collateral source is proceeds from life insurance policies paid or payable to surviving claimants in wrongful death cases. According to current information published by the National Association of Mutual Insurance Companies, of the twenty four states that have enacted collateral source rules, ten are identified as not allowing the use of life insurance proceeds to offset awards for special damages.³ This number is at least one greater as while this source does not identify Florida in this group, the Florida statute clearly prohibits the consideration of life insurance proceeds (i.e., Florida Statutes XLV 768.76 (2)(a)2). This prohibition may well apply, at least in case law, in many of the states that have no statutory rule.

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wrongful death actions and income disability insurance payments in personal injury actions to offset awards for special damages quite likely produces sub-optimal economic results for society in its entirety. Also, as a result of the violation of the principle of indemnity, these prohibitions produce exactly the same result that caps on awards for non-economic damages are argued to eliminate.

In the remainder of this piece, a simple micro-economic model is developed to show that collateral source rules that allow claimants to be over indemnified because of prohibitions regarding the use of un-subrogated insurance benefits as offsets to economic damage awards produce economically inefficient results, with claimants receiving windfalls at the expense of the

rest of society. While there are multiple sources of un-subrogated insurance benefits to which the model could be applied, in the interest of simplicity, life insurance benefits are used as the object of analysis.

The model is based on the theory of consumer choice and employs the Edgeworth-Bowley box technique.⁴ The analysis shows the method in which individuals or groups can negotiate allocations of scarce economic goods so as to achieve an optimum result. An optimum result simply means that one party cannot make itself better off in the sense of gaining total Utility (i.e., satisfaction) without causing another party to suffer a loss of Utility. The model assumes that since larger stocks of financial resources allow an individual or group access to larger amounts of consumption goods then, *ceteris paribus*, the greater the level of access to financial resources, the greater the level of Utility that can be achieved. The *ceteris paribus* condition means that there is no reference in the model to a loss of Utility to surviving claimants because of the decedent's absence. Indeed, attempting to include this general damage in the model would be a fruitless exercise since the science of Economics has not to this day been able to unlock the secret of attaching monetary value to psychological pain or pleasure.

Recognizing that the terms capital and wealth are interchangeable, two economic goods are used in the analysis, human capital (wealth) and financial capital (wealth). The human capital (HC) good is measured by the present money value of the prospective earning and service producing capacity of a decedent absent, of course, his or her death. Financial wealth is employed as a surrogate for real non-human capital (e.g., land, natural resources, structures, capital goods, etc.) since the monetary value of the stock of real non-human capital is reflected by the monetary value of the claims held against it such as notes, mortgages, equities, and deeds on unencumbered real property. These claims are called financial capital (FC). In the model, financial capital is utilized in place of real non-human capital since it is typically the asset with which claimants are indemnified for their found losses.

In the analysis that follows, *society in entirety* is defined as the whole of society including a pre-decedent and that person's dependant(s) in the pre-death case and the surviving dependent claimant(s) in the post death case. *Society in general* is defined as society in entirety excluding a pre-decedent and his or her dependent(s)/surviving dependent claimant(s). The latter is/are referred to as the claimant group. Further, in order to better understand the model and the conclusions that it allows, it is necessary to recognize that, except in cases involving individuals who possess absolutely no human capital, society in entirety is a net financial loser when anyone dies whether because of a wrongful act by a tortfeasor or by natural causes. This is because the stock of human capital of society in entirety is reduced.

The question at issue is the following: what is the fairest and most economically efficient manner in which to indemnify surviving claimant(s) in wrongful death actions for special damages when life insurance benefits are available? Stated alternatively, what manner of indemnification would produce an economically inefficient solution for society in entirety and how can this solution be avoided?

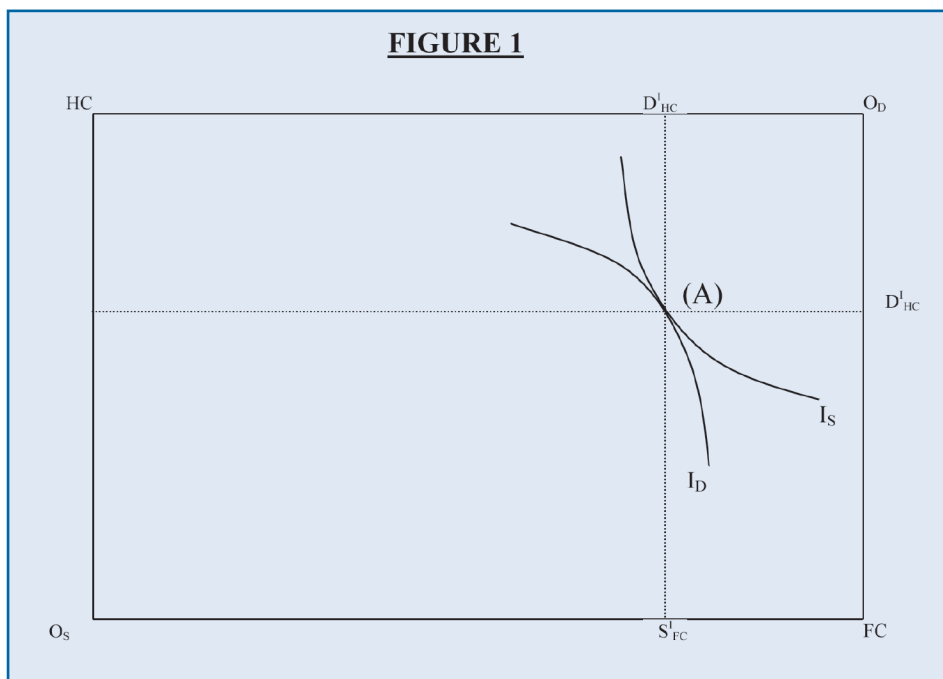
Human capital and financial capital, HC and FC respectively, are substitute Utility producing goods in the form of assets since both create purchasing power which allows access to economic goods that produce Utility. Thus, economic units can trade off varying quantities of either against the other and maintain a constant level of Utility. This could be a large stock of HC and little if any FC, vice versa, or any combination in between. Note again that the model does not attempt to assign a monetary value to potential psychological pain or pleasure. The Utility or disutility (i.e., dissatisfaction) that any given economic unit may derive from laboring as opposed to idling because of their stock of FC, or lack thereof, is not subject to monetary valuation by the model. The only issue considered is the most fair and economically efficient method of monetary indemnification of the surviving claimant group in tort actions for the special damages they claim from the loss of a decedent's HC.

Figure 1 shows an initial endowment of FC and pre-death HC for an individual whose death is at issue in a tort action, and society in general with FC and HC measured on the horizontal and vertical axis respectively. The origin for the decedent is indicated as O_D and that of society in general as O_S . The decedent's pre-death endowment of HC is $O_D - D_{HC}^1$ and his or her pre-death endowment of FC is $O_D - D_{FC}^1$. Likewise, the endowment of society in general is indicated as $O_S - S_{HC}^1$ and $O_S - S_{FC}^1$, respectively.

I_D and I_S are the pre-death indifference curves for the decedent and his or her dependents (with the soon to be decedent and his or her dependents treated as a single economic unit as related to the decedent's endowment of HC and FC) and society in general as reflected by the subscripts D and S. Indifference curves are constructs utilized in the theory of consumer choice to reflect three conditions relevant to this analysis. The first condition is that while economic goods create positive Utility as opposed to disutility (i.e., satisfaction as opposed to dissatisfaction), on the margin this Utility declines as more and

more of any given economic good is consumed. By way of example, a person may experience more Utility by consuming two slices of apple pie than by having only one slice, but the second slice produces a smaller increase in total satisfaction than was produced by the first slice.

Secondly, in respect of two Utility producing goods, the consumption of differing combinations of any two goods can produce a constant level of Utility. Given the first condition, the



declining marginal Utility from an increased volume of consumption of one good and the increasing marginal Utility from a decreased volume of consumption of the other produces the mathematical result, shown visually in Figure 1, that indifference curves curve away from an endowment origin (i.e., are convex to an endowment origin). In other words, along a given indifference curve, the more of one good consumed and the less of the other, the more of the former an economic unit could sacrifice in order to gain an additional unit of the latter and maintain the same level of satisfaction. The exchange ratio is referred to as the marginal rate of substitution in consumption.

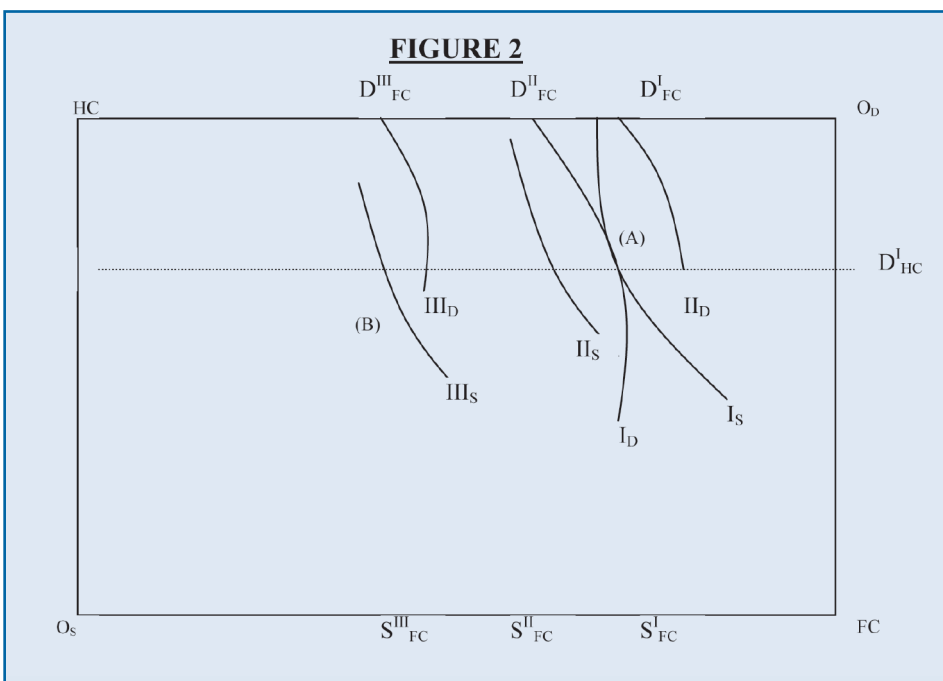
Third, the theory of consumer choice assumes that consumers prefer more to less. This implies that the more of either one or both of two available economic goods the consumer has access to, the greater their level of Utility. Thus, the further the indifference curve that an economic unit operates on is from its endowment origin, the greater its level of satisfaction. Concomitantly, the closer to its endowment origin the indifference curve on which an economic unit operates, the lower its level of Utility. The greater the endowment of HC and FC, the further from the endowment origin the indifference curve that

a rational, utility maximizing economic unit will chose to operate on since only in this way will they maximize total Utility.

Point A in Figure 1 reflects an initial point of Utility maximization for society in general and an individual in their pre-death state. Assuming rational, Utility maximizing behavior on the part of both, they operate to achieve the highest level of total Utility possible, given their endowments of HC and FC. (It should be noted that the allocation of the endowment of HC

with the recovery effort directed at the alleged tortfeasor, a member of society in general.

Following the principle of indemnity and assuming the alleged tortfeasor is found liable, the goal is to restore the surviving claimant group to its pre-death level of Utility. Since restoration of the lost HC is not possible, this can only be achieved by sufficient monetary compensation from society in general to allow a move from point D_{FC}^I to point D_{FC}^{II} as this will



allow a return to I_D .⁵ This monetary compensation produces a loss of society's in general endowment of FC indicated by the distance $S_{FC}^I - S_{FC}^{II}$ and a corresponding loss of total Utility represented by the move from I_S to II_S which is deemed to be fair if it reasonably reflects the actual special damages incurred.

However, if the liable tortfeasor is required to pay the entire amount of awarded damages equal to $D_{FC}^I - D_{FC}^{II}$ (which is identical to $S_{FC}^I - S_{FC}^{II}$) without an offset for available third party payments that mitigate the found loss, society in general will bear an additional cost and the solution will not only be unreasonable but also likely be economically inefficient. In short, it will create a windfall to the surviving claimant group at the expense of society in general. This result is shown by points D_{FC}^{III} and S_{FC}^{III} . In this scenario, the

and FC for the individual is visually exaggerated for the purpose of clarity. In reality, even for the greatest endowed economic units, their endowment relative to society in general would be nearly touching O_D). Point A also represents an Edgeworth optimal solution since neither party could improve its position, reflected visually as a movement toward the other party's origin, without reducing the level of total Utility of the other party.

Point A is duplicated in Figure 2, again reflecting the pre-death total Utility state for both parties represented by I_D and I_S . Indifference curve II_D indicates the loss of total Utility to a decedent's surviving claimant group because of the total loss of his or her HC as it is closer to O_D than was I_D . The post death, pre-recovery endowment had been changed to the point indicated as D_{FC}^I as the decedent's entire HC endowment has been lost. Since the endowment of society in general has not changed, there is a net loss of HC to society in entirety reflected by the gap between point A on society's in general indifference curve I_S and D_{FC}^I . In the case of deaths not involving an alleged tort, this is simply a net loss to society in entirety. However, in tort actions, the surviving dependent claimant(s) are afforded an opportunity to recover their loss

claimant group actually gains total Utility and society in general loses more than warranted. Because of the prohibition to recognize sources of third party compensation, the claimant group ends up at a higher level of total Utility than in the pre-death state as reflected by III_D . Correspondingly, society in general loses more total Utility than justified by the wrongful act and ends up at point B on III_S which is dictated by its unaltered endowment of HC.

A valid question then becomes, so what? Does this not simply represent a transfer of financial wealth from society in general to the other members of society in entirety (i.e., the recovering litigants). Where is the source of economic inefficiency? The answer to this lies in the net impact of such a transfer on real human and non-human capital creation. There are, after all, only two sources available to tortfeasors for the required monetary restitution: (1) coverage under liability insurance policies and, (2) their financial and human capital endowments. In the case of the former, incurred losses of property and casualty insurers are higher than they otherwise would be. This produces higher premium rates for society in entirety than would be the case if the third party payments were recog-

nized and, therefore, less financial resources available for other uses. If the found damages are paid out of pocket by the negligent tortfeasor, whether a business, government entity, or individual, their financial resources are reduced. In either case, the financial capacity to fund capital creation is reduced. The quintessential question is then, can it be shown that over indemnified claimants are capable of generating real capital creation at least to the same level as the reduction in capacity caused by the windfall? If not, there is a net loss of future income to society in entirety since its future endowment of real capital will be less than would otherwise be the case. While this is an empirical question, subjectively, the answer is probably no. After all, the purpose of business is to create and utilize real non-human and human capital. Governments also create real capital through investment in social infrastructure and education.

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When life insurance benefits are available and not allowed as an offset to special damage awards, the additional loss of financial capital to society in general is measured by the benefits received by surviving dependent claimant groups from this source. Though no ready estimate is available for the value of life insurance benefits paid or payable on the life of decedents' whose deaths are at issue in wrongful death cases, it is certainly not trivial. As an example, the American Council of Life Insurers has reported that over \$50.6 billion was paid to beneficiaries under life insurance policies in 2003 by U.S. companies.⁶ Even a fraction of this sum, considered over a period of years, would be a substantial amount of investment capital.

There is a subsidiary issue related to the use of third party payments as offsets to special damage awards. In particular, it could be argued in the interest of equity that in those cases in which a plaintiff in a personal injury action, a decedent in a wrongful death action, or any member of a claimant group has incurred an expense to procure the loss mitigating benefit, such as policy premiums, the offset should be reduced by these expenses, or the present value thereof. In the case of life insurance this would, by example, be the present value at the time of the award of all policy premiums paid through the date of death.⁷ This allowance would seem to provide a more equitable

solution since had the premiums not been paid, there would have been more disposable income available to the plaintiff or decedent. As a consequence, either more monetary support from the income produced by the decedent's endowment of human capital would have been available for other uses, or a larger endowment of financial capital could have been accumulated. Also, by not recognizing this type of expense, decedent/plaintiffs would appear to be penalized for the responsible act of providing such protection against potential future economic loss from injury or death.

While this approach appears to produce a more equitable solution for the claimant group, it does just the opposite in producing a less than equitable solution for society in general. It would shift the location of the indifference curve of the claimant group after final disposition from I_D very slightly toward O_s in Figure 2 and result in a net gain to the claimant group, however modest, in total Utility compared to the pre-incident state. The reason for this is that such a reduction in the collateral source offset does not recognize the Utility producing attribute of the purchased protection. More specifically, is it not reasonable to assume that at least some Utility is created by the sense of security that owning the protection provides? If not, why would anyone purchase it? By allowing recovery of the expense of acquiring it, one would be assuming just the opposite. In particular, the assumption would be that the protection itself produced lower marginal Utility than would have been created by the other economic goods that could have otherwise been purchased, including additions to the FC endowment. In short, the assumption would be that the ownership of such protection creates disutility (i.e., reduced satisfaction). This proposition is nonsense. If economic units are indeed rational and utility maximizing, they do not purposefully allocate their scarce economic resources in a manner that causes dissatisfaction. Referring again to Figure 2, they do not voluntarily act in a manner that knowingly would cause them to move from I_D to, as an example, II_D .

Therefore, by allowing this type of subrogation, the past Utility created by ownership of sources of financial protection (e.g., life insurance) would be neglected and the claimant group would actually be paid for the satisfaction that it benefited from in the past. This is precisely the problem with collateral source rules that prohibit certain types of offsets for which subrogation rights either do not exist or have been waived. Also, equating the value of the *assumed* past disutility derived from the feeling of security provided by the source of protection to a monetary valuation based on the past cost of the protection is tantamount to assigning a monetary value to Utility. As noted above, the social science of economics has not yet developed a technique to quantify the Utility produced by pleasure or, in this case, the *assumed* disutility resulting from a conscious decision to allocate



a portion of one's purchasing power to providing security against potential future economic loss.

In conclusion, collateral source rules that prohibit the consideration of loss mitigating payments by third parties cause both net Utility gains to winning claimants (from strictly a financial perspective) and, in all likelihood, a net loss of real capital creation for society in entirety. By allowing consideration of these loss-mitigating payments, a more equitable and economically efficient solution would be achieved. This analysis has been directed strictly to the issue of life insurance benefits. Clearly there are other sources of such payments that should be included in tort reform considerations. **BLB**

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¹ Special damages include direct expenses incurred as a result of an alleged tort such as medical and burial expenses as well as losses resulting from a decrease in an injured party's capacity to create income and provide personal services. In the case of personal injury, the latter is measured by the monetary value of lost earning capacity and the cost of replacement services. In the case of wrongful death, it is measured by the loss of support and net estate accumulation from a decedent's prospective future earning capacity, as well the monetary value of personal services to the surviving claimants that will become a necessary expense to them. The latter is commonly referred to as household services. Special damages are also referred to as economic damages. General damages are psychological in nature such as loss of companionship and consortium in death actions and pain and suffering in personal injury actions.

² See, e.g., ALA. CODE § 6-5-520 (1975) applicable only in product liability cases; ARIZ. REV. STAT. § 12-565 (1984) applicable only in medical malpractice cases.

³ National Association of Mutual Insurance Companies, *at* www.namic.org/reports/tortReform/CollateralSourceRule.asp (last visited June 12, 2005).

⁴ See C.E. FERGUSON, MICROECONOMIC THEORY, pp. 61-64, 362-368 (Richard D. Irwin, Inc.) (1966).

⁵ In wrongful death actions taxes and personal consumption are netted from the decedent's prospective pre-death earning capacity before allocating damages to loss of support and net estate accumulation. In the model, these adjustments are treated as being implicit in the claimant group's indifference curves in order to simplify the analysis.

⁶ American Council of Life Insurers, *Life Insurers Fact Book 2004*, Table 5.2.

⁷ See MONT. CODE ANN. § 27-1-308 (1987) (allowing to some degree this type of offset for amounts paid or payable from collateral sources that do not have the right of subrogation).