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THE FEDERALIST SOCIETY, CONFERENCE: CIVIL JUSTICE AND THE LITIGATION PROCESS: DO THE MERITS AND THE SEARCH FOR TRUTH MATTER ANYMORE?, CONFERENCE DIALOGUE, DAY ONE, PANEL THREE: INSURANCE AND THE LITIGATION PROCESS

Robert L. Lofts

Hon. Dennis Jacobs

Richard Scruggs

Richard A. Epstein

Hon. Lynne Abraham

PANEL THREE:
INSURANCE AND THE LITIGATION PROCESS

OPENING

ROBERT L. LOFTS, MODERATOR*

We have a distinguished panel, as all Federalist panels are, starting with Lynne Abraham, who is the District Attorney of the City of Philadelphia; Richard Scruggs, who has been mentioned a number of times here today, from Mississippi; Professor Richard Epstein from the University of Chicago, who has been mentioned in glowing terms and, I think, not so glowing by a few members of the audience; and Judge Dennis Jacobs of the Second Circuit. I am Bob Lofts, and I am given the title of moderator, but I have been given no stun gun with which to control my panel.

Insurance is our topic and I have only a few observations to offer on insurance and its impact on the litigation world. These come anecdotally and not with data. The anecdotes are based on my thirty years of practice in San Francisco, which may cause you to discount even the anecdotes as being nonrepresentational.

First, at a basic level, insurance does increase litigation because with the typical fender-bender, nobody is going to spend the time and money to sue someone who has no insurance and little or no money. Moving up the scale, one who has some money, but not a lot, and no insurance, will probably not become a defendant either. That is because it is not going to be worth the effort to chase that person down. It is also because of a factor that figures not only in the low end of cases, but in the high end, big money cases as well. Plaintiffs' lawyers are not collection lawyers. They do not know how to enforce judgments. It is not a good use of their time.

This impacts settlements in a number of ways. It starts with policy limits. On the insurance defense side, the policy is most likely to be the top dollar, because the plaintiff's lawyer does not want to make the effort to go over the policy limits against the insured. However, if there is bad faith or if one can open the policy and go against the insurance company, that is a different story. But, just going against the insured to try to recover the insurance and collect the excess is not something the plaintiff's attorney is interested in doing. So the defense side knows it can buy peace with that policy limit. The defense side also knows the plaintiff is pushing for a high number to settle and, in many cases, the insured is also

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pushing for a big number to settle, particularly in the case of lawyers, accountants, doctors, directors, and officers.

Many of these people have significant assets beyond insurance, but I am not aware of any significant number of cases where plaintiffs' lawyers attempted to pursue assets beyond the insurance. Thus, the question becomes the right between plaintiff and defendant over the policy limits, and there are different people on different sides. As the former managing partner of a law firm, I devoted a great deal of attention to what is the appropriate level of insurance for professional practice.

The appropriate level of insurance really has nothing to do with the amount of damage that my partners and I are capable of inflicting, such as a bad securities offering or a bad form for a lender on which hundreds of millions of dollars are lent in violation of the Truth in Lending Act.[1] There is not enough insurance in the world to cover some of the damage that a lawyer can do. But there is enough insurance to buy a settlement from a plaintiff's lawyer, and that is the kind of magic number we are thinking about. We want a nice fat number that is enough to make the plaintiffs go away. It is not going to make anybody whole, but at least the plaintiffs are gone.

The second area that insurance impacts has more to do with process than substance: the plaintiff normally gets the insurance policy. The plaintiff is going to get the reservation of rights letter. He is going to know about coverage disputes, and he is going to evaluate that in terms of the demand that he makes—how much he thinks he can get—and it will impact the insurance company and how much they will offer. So it is a rational system.

However, problems arise when someone enters the system who does not know how to play the game. Trouble can arise when dealing with such a party. But otherwise, it is a system where the participants are accustomed to dealing in certain ritual, and plaintiffs' lawyers understand the ritual, the defense lawyers understand the ritual, and everyone understands that they are really in the same situation—a claims settlement process. It is a complicated and costly one, but it is really a claims settlement process.

The insurance companies know that something is going to go off the rails once in a while; they operate on an actuarial basis and expect their lawyers to perform, but they expect them to perform actuarially, as well. They have to be right most of the time and not too far wrong the rest of the time. If they do that, the whole system will work. Somebody is

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1. *See* Truth in Lending Act, 15 U.S.C. §§ 1601-1667 (1994). *See generally* Robert A. Cook, *The Truth in Lending Act—A Review in Light of Its Original Purpose*, 49 CONSUMER FIN. L. REV. Q. 357 (1995).

paying for all of this, of course, but hopefully the people who are buying the insurance are, as a group, paying for it.

The effect on the process, as I said, is pretty straightforward. In larger scale cases the insurance tends to diminish in importance. Certainly, there are large solvent defendants who have a great deal of insurance, but we do not see it in the typical product liability case. There will be layers of coverage, there will be very large deductibles, a retention, and a very complicated insurance structure that does not impact the process very much, because the insureds in those instances control the defense. They control the choice of counsel and how the case is to be defended.

The larger cases with multiple insurers are good for lawyers because, frequently, excess carriers claim that the primary carrier should have settled within the primary limits and failed to, and, therefore, the excess carrier is not liable at all. Also, as we see with alarming frequency, the excess carriers say they did not even know there was a case until the judgment came in, so they did not have any opportunity to protect themselves. Insurance thereby creates more litigation among insurers passing the buck around, and that is going to be our theme this afternoon.

TEN WHOLE MINUTES IN WHICH NOTHING BAD IS SAID ABOUT INSURANCE COMPANIES

THE HONORABLE DENNIS JACOBS, FIRST PANELIST*

It has been frequently claimed that tort law principles are ruining the insurance companies by driving up premiums, narrowing coverage, and making insurance unavailable. The topic I have been asked to talk about today is a more provocative one, and that is the question of what influence liability insurance has on the state of our tort law, which is assumed to be bad and is often referred to as the tort crisis.

My view is that though there may be a tort crisis, and although insurance practices probably make it worse, there is not much that can be done about it if insurance is to continue to work as it should. It certainly appears that insurance companies, which hold the purse strings, could exercise that power to fix what is wrong with tort law, but I do not think the state insurance commissioners would think much of that. And if they did approve, no one would want to buy an insurance policy that protects the tort system instead of the policyholder. In any event, I am skeptical about the idea that insurance, properly understood, is a suitable vehicle for reforming what has gone haywire with our tort system and its doctrines, practices, and verdicts.

Why is insurance such a poor instrument when it has such actual advantages for correcting the tort system? First of all, insurance is a contract, and this contract is a two-party affair. The public, of course, has a strong interest in the vigorous enforcement of insurance polices. But the public in the ordinary sense is not really a beneficiary of an insurance policy (except in situations such as uninsured motorist schemes and other exotica).

Insurance companies are obliged by contract to approach the defense of each risk in terms of protecting the policyholder in that exigency, and any other goal should be peripheral. Not only is that the way it is most of the time, that is the way it should be, at least when an insurance company is living up to its contractual obligations. If the overall system is thereby disserved, then that is probably for the overall system to sort out and compensate for.

The reason insurance is a bad instrument for correcting tort law is reflected in a simple review of the basic terms of an insurance policy. The two most elementary contract terms of primary and umbrella liability coverage are the indemnity clause and the defense clause.

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* Judge, United States Court of Appeals for the Second Circuit. I am indebted to Ben Lawsky for his advice and editorial assistance.

The indemnity obligation binds an insurance company to reimburse the policyholder for sums that are paid in damages "on account of" bodily injury or property damage. This clause has very little to do with the merits of a claim. The focus is on the money that is paid or that has to be paid, and this is a judgment that does not discriminate much between good claims and bad claims (except perhaps in terms of dollar value). Thus, the most basic terms of a liability policy contemplate coverage, subject to exclusions, even for bad claims, false claims, and other such claims in which the plaintiff should take nothing because, in a perfect tort system, there would be no liability at all.

If insurance worked any other way, it would not be worth having. Since an insurance policy will cover a verdict that is unjust, it seems to me it must also cover a settlement even of groundless claims—that is, there should be coverage if there is even a slight prospect that the plaintiff will recover on the claims. That does not mean that groundless claims are not worth less than good ones, but it does mean that the insurance company has to deal with them and has to represent the interests of the policyholder in dealing with them.

Seen in this light, liability insurance protects the policyholder against at least two kinds of risks within the scope of the coverage. One is losses that the insured (or its product) causes and should therefore pay for. The other is losses that are caused by the misfiring of the tort system and the justice system. Sometimes, those dangers intimidate insurers into settling by the sheer magnitude of the potential exposure, irrespective of the merits. One example is provided by the Agent Orange cases.[1] In approving a $180 million fund—virtually all of it insurance money—created to settle that mammoth litigation, the district court acknowledged that there was little proof supporting the theory that Agent Orange caused bodily injury in the first place.[2] Though that is probably a misfiring of the tort system in certain respects, no one can doubt that the insurers' contributions to that fund protected the manufacturers from a great peril that was covered by insurance.

A similar effect is seen if one looks at the other basic benefit people buy when they purchase primary or umbrella liability insurance, and that is defense. The defense clause ordinarily includes, in addition to the

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1. *See In re* "Agent Orange" Prod. Liab. Litig., 597 F. Supp 740 (E.D.N.Y. 1984), *aff'd*, 818 F.2d 145 (2d Cir. 1987); *see also In re* "Agent Orange" Prod. Liab. Litig., 996 F.2d 1425 (2d Cir. 1993). *See generally* Robert L. Rapin, *Tort System on Trial*, 98 YALE L.J. 813 (1989) (reviewing PETER SCHUCK, AGENT ORANGE ON TRIAL: MASS TOXIC DISASTERS IN THE COURT (1987)).

2. *See In re "Agent Orange" Prod. Liab. Litig.*, 597 F. Supp. at 775-95. The district court pointed out that a summary judgment motion on the causation issue had not been made by the defendants. *See id.* at 782.

stated policy limits, an undertaking to defend the policyholder on potentially covered claims and to do so at the expense of the insurance company. Obviously, this is a very expensive undertaking and is often much more expensive than the indemnity payout. Of course, when the defense is successful, it can be very cost-effective. On the other hand, even a successful defense can be an enormous expenditure and may dwarf any settlement. Insurers thereby have an obvious incentive to value claims early and to settle them—or at least one would think so. Few trial judges would characterize insurance claims personnel as supine, but there is an incentive to settle that is created by the defense clause, and insurance companies will very carefully gauge what their outlay is for defense in deciding and planning whether to settle certain cases.

The defense clause becomes a very powerful incentive in a long-tailed mass tort situation that goes back many years and that involves large insurance funds paid under old insurance policies. The old policies may all have large limits remaining on them, but nobody ever thought they were going to be worth anything. The insurance companies reacted first with shock, but they are now educated to the fact that they have many old, say twenty-year-old, insurance policies, and that they have to pay their limits. The companies thus have a disincentive to fight those claims case-by-case and item-by-item. If they are going to pay their policy limits, they would just as soon pay them and not pay for a scorched-earth, burdensome, last-ditch series of defenses that will be in addition to the policy limits.

It is arguable, of course, that this creates some of the problems that we see in mass tort litigation. It is a chain reaction, to some extent. The availability of funds from these old insurance policies to settle mass tort claims, and the disincentive to litigate the claims under them, encourage the wholesale enlistment of claimants who seek some sliver of a proposed enormous fund. Then, since the insurance company and the manufacturer of a product want to have a global settlement that takes in every possible claimant, the threshold of injury is often lowered until the point where a claim can be supported by symptoms that cannot be medically verified. And of course, sometimes there may be claims based on medical monitoring where absolutely no bodily injury, except in the future, is contemplated at all.

The effect of this, in turn, is to assure that any fund of any size will be inadequate to fund the loss, even if the tort loss itself—the actual bodily injury or the property damage—is very small or largely illusory. Yet for insurance companies and for their manufacturer insureds, the risk of non-contribution can be unacceptably great. If one manufacturer is left out of an industry-wide global settlement, all the litigation artillery eventually wheels around to focus on that one manufacturer—and its unhappy insurance company.

Through the handling of claims, the management of defense, and the valuation of the claims, there is no doubt that insurers exercise a measure of control over the costs of defense and, less effectively, over the amount of the liability payout. However, though insurers have the power to control these things in certain respects, it is very important to keep in mind, for purposes of gauging the ability of the insurance system to correct problems in the tort area, that insurance companies owe a single-minded duty of loyalty to the policyholder.

This loyalty principle of course maximizes the value of the insurance product, but it is also necessary to counteract the built-in conflicts of interests that insurance companies have when they defend policyholders at their own expense, in addition to the policy limits. This ethic, this single-minded duty of loyalty to an insured, does not come naturally to all insurance companies. However, it is heavily reinforced by outside influences, including market influence—people will buy insurance that gives them coverage, but they will not buy insurance that is illusory—and, of course, legal coercion.

In California and New Jersey, and maybe elsewhere, an insurance company can be treated as a fiduciary of the policyholder.[3] There are some thirty states—the first one was California—that have recognized a covenant of good faith and fair dealing implied by law in every insurance policy.[4] Of course, there is nothing unusual about a covenant of good faith and fair dealing in contract law, but this statutory duty is not grounded in the contract itself, because a breach of the insurance company duty of good faith and fair dealings is treated as a *tort*. Bad faith conduct under these tort statutes includes the denial of coverage that is later found to have existed, a mechanism that increases the flow of insurance money because it inhibits the assertion of arguable and even meritorious coverage defenses.

Bad faith refusal to accept a settlement offer that is found to be reasonable can also result in tort liability.[5] Of course, the determination as to whether the settlement offer was reasonable is one that is made after the jury has rendered its verdict, and that is another stimulus to the flow

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3. *See* Frommoethelydo v. Fire Ins. Exch., 721 P.2d 41, 44 (Cal. 1986); Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 323 A.2d 495, 505, 507 (N.J. 1974).

4. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES 229, 571-82 (8th ed. 1995) (listing the following states: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Idaho, Iowa, Kentucky, Maine, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Texas, Vermont, Washington, Wisconsin, Wyoming, and the Virgin Islands).

5. *See id.* at 534-35.

of insurance money. The tort remedies that are available to punish the failure to settle include, depending upon the state: the attorney's fees that are incurred to win coverage;[6] the policyholder's mental suffering;[7] and, of course, in some states, punitive damages.[8] Moreover, in many jurisdictions, intentional misconduct is not an element of this statutory tort defense.[9] Liability attaches even if the insurance company had a good faith basis for contesting the coverage or for not paying the claim.

It is easy to see how this affects coverage decisions and tends to hydraulically draw insurance cash into the tort system.[10] In some states, either by statute or under common law, a bad faith failure of an insurance company to pursue an opportunity to settle a claim within the policy limits will open up the insurer to pay any resulting judgment, even if it exceeds the policy limits.[11] It may not be enough for the insurer to await passively an offer to settle within the limits; the insurer owes the policyholder a duty to go out and initiate discussions, if necessary, and to follow up any promising settlement initiative. This is a very sharp spur, and I would think that this certainly tends to increase the flow of money. And if the tort crisis is viewed as something that is fueled by money, then I guess insurance is fueling the tort crisis.

In fact, what is seen as the tort crisis today is, in part, the fallout from the last great effort to utilize insurance as an engine of social progress: the distribution of losses arising from the use of products, via strict liability. As one commentator has written:

> What allowed the rapid and successful development of tort law into a significant compensation system was the emergence of a

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6. *See* Kilroy Indus. v. United Pac. Ins. Co., 608 F. Supp. 847, 859 (C.D. Cal. 1985). *See generally* OSTRAGER & NEWMAN, *supra* note 4, at 529-31, 557-67.

7. *See, e.g.*, Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1040-42 (Cal. 1973); Crisci v. Security Ins. Co., 426 P.2d 173, 179 (Cal. 1967); Farmers Group, Inc. v. Trimble, 658 P.2d 1370, 1376-77 (Colo. Ct. App. 1982), *aff'd en banc*, 691 P.2d 1138 (Colo. 1984); Farmers Home Mut. Ins. Co. v. Fiscus, 725 P.2d 234, 236 (Nev. 1986); Twin City Fire Ins. v. Davis, 904 S.W.2d 663, 665 (Tex. 1995).

8. *See generally* OSTRAGER & NEWMAN, *supra* note 4, at 532, 566.

9. *See generally id.* at 532, 560-67.

10. The National Association of Insurance Commissioners promulgates a model state Unfair Insurance Practices Act. Versions have been adopted by 48 states, although only five recognize a private right of action under the statute: Kentucky, New Mexico, North Dakota, Montana, and West Virginia. Nevertheless, in other states, the model Act reflects standards and obligations. Among those business practices barred by the Act in California is the failure to attempt in good faith to settle claims in which liability is reasonably clear. *See generally* OSTRAGER & NEWMAN, *supra* note 4, at 536-43.

11. *See* Gordon v. Nationwide Mut. Ins. Co., 285 N.E.2d 849, 854 (N.Y. 1972).

> national insurance pool funded through premiums paid by large corporate enterprises, in particular, products manufacturers. The existence of seemingly inexhaustible financial resources allowed courts and commentators to focus on the alleged socioeconomic benefits to be derived from shifting the cost of accidents from individual victims to large corporate enterprises that could either buy insurance or self-insure.[12]

However, the expansion of tort liabilities has driven some liability coverages from the market, and made other coverages prohibitively expensive.[13]

Today, courts continue to treat insurance coverage and insurance money as public resources suitable for achieving non-insurance goals, such as environmental improvement[14] or asbestos cleanup in the schools.[15] Fortunately, courts do not have appropriated funds to spend on the public good, but as George Priest has pointed out, the availability of insurance has been useful in allowing courts to realize and implement social goals.[16] Courts have done so through a long-term, slow, incremental process of restricting defenses to tort liability (such as contributory negligence) by promoting doctrines that tend to expand liability, and by "adopting the maximization of insurance coverage as the principal interpretative objective in insurance disputes."[17]

Of course, it is a familiar principle of insurance coverage law that coverage grants be construed broadly and that exclusions be construed narrowly. But when laudable social objectives can be accomplished with insurance money, some courts—emphatically not all—simply invent coverages and reduce exclusions to the vanishing point. Because insurance policies deal with future events, the contract terms are, by

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12. Robert G. Berger, *The Impact of Tort Law Developments on Insurance: The Availability/Affordability Crisis and Its Potential Solution*, 37 AM. U. L. REV. 285, 308 (1988); *see also* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1534-35 (1987).

13. As Robert Chesler has explained:

> [T]he whole concept of strict liability is based on the ability of corporations to abdicate those risks to the insurance industry, which then spreads them evenly across society as a whole. If corporations are unable to use insurance to spread the risk of strict liability, the whole scheme is called into question.

Joanne Wojcik, *Deja Vu All over Again: New Coverage Suits Build on Old Cases*, BUS. INS., Feb. 29, 1996, at 2.

14. *See generally* OSTRAGER & NEWMAN, *supra* note 4, at 401-92.

15. *See generally id.*

16. *See* Priest, *supra* note 12, at 1534-39.

17. *Id.* at 1534-35.

nature, general. In order to maximize or find coverage, some courts treat that generality as breadth or vagueness—or best of all, as *ambiguity*, because ambiguous clauses are construed against the drafters. Moreover, a number of opinions, overtly or subliminally, treat the maximization of insurance proceeds for environmental cleanup as a public interest that is appropriate to consider in construing insurance contracts.[18]

It is wrong to say that insurance companies lack the means to influence the tort system. Obviously, the system of fixing premiums based on loss experience has been a way of controlling behavior. And there have always been consultancy services, such as work site safety inspections, that tend to reduce the amount of loss, the amount of risk, and the amount of negligence out there in the world. But insurers seem to have no way to influence the growth of liabilities that are *not* based on the policyholder's failure or negligence. If the loss is the result of mass hysteria or an opportunistic attack on a product or industry by tort lawyers, there is little insurers can do to anticipate or to reduce that risk.

In sum, it is undeniable that insurance furnishes the money that fuels the tort system, and that the insurance system—when it operates along commercially fair and moral lines—increases the flow of cash. But blaming insurance companies for what is wrong with the tort system is a lot like blaming arson on oxygen.

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18. *See* Shapiro v. Public Serv. Mut. Ins. Co., 477 N.E.2d 146 (Mass. App. Ct. 1985); Morton Int'l, Inc. v. General Accident Ins. Co., 629 A.2d 831 (N.J. 1993), *cert. denied*, 512 U.S. 1245 (1994); Jackson Township Mun. Utils. Auth. v. Hartford Accident & Indem. Co., 451 A.2d 990 (N.J. Super. Ct. Law Div. 1982). *See generally* OSTRAGER & NEWMAN, *supra* note 4, at 426.

TOBACCO LITIGATION: A PROBLEM THAT NEEDS A SOLUTION*

RICHARD SCRUGGS, SECOND PANELIST**

I am going to do my best, and there is going to be a test at the end of what I say. Anybody who can find anything about insurance in what I say is going to get a gold star. We have been wrestling with how to blend tobacco litigation into a discussion on the principles of insurance and insurance fraud; however, I will provide an account of what is going on with tobacco litigation.

Right now, sixteen states have filed suit against the tobacco industry to recover the health care costs of treating indigent smokers with tobacco-related illnesses.[1] Part and parcel of these lawsuits are efforts to enjoin marketing techniques that appeal to teenagers and adolescents.[2] While smoking is declining among most adult populations, it has leveled off and is even starting to increase among our youth, and that portends drastic consequences in the future.

Between one and two of every ten health care dollars are spent treating tobacco-related illnesses.[3] Furthermore, people who smoke and get sick from using tobacco products are disproportionately among the poor and disadvantaged.[4] My small state of Mississippi, for example, is one of the poorest states in the country, with a large minority population. We also have a large poor population and the highest percentage of

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1. Attorney General Michael Moore of Mississippi was the first to sue the tobacco industry in an attempt to recover the state's health care expenses. *See* John Schwartz, *In Tobacco Suits, States Find Strength in Numbers; Mississippi Attorney General Rallies Coalition of Colleagues in Landmark Legal Battle*, WASH. POST, May 18, 1997, at A6. On March 13, 1997, the Mississippi Supreme Court ruled that Attorney General Moore's suit seeking to recoup the state's health care costs can go to trial. *See Mississippi High Court Rejects Move to Block Tobacco Trial*, WASH. POST, Mar. 14, 1997, at A3. As of May 1997, 29 states had filed suit against the tobacco industry. *See* Schwartz, *supra*, at A6.

2. *See* Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect Children and Adolescents, 61 Fed. Reg. 44,396 (1996) (to be codified at 21 C.F.R. §§ 801, 803, 804, 807, 820, 897).

3. *See generally* Raymond E. Gangarosa et al., *Suits by Public Hospitals to Recover Expenditures for the Treatment of Disease, Injury and Disability Caused by Tobacco and Alcohol*, 22 FORDHAM URB. L.J. 81, 81-103 (1994).

4. *See id.* at 87.

population in the country on Medicaid.[5] One out of every five citizens in our state is on Medicaid. That burden is straining our health delivery system to the limit. This is not only true in Mississippi, but also true in a lot of other southern and northern states. States like New Jersey, Minnesota, Michigan, and Washington would not have joined this litigation if the costs were not also straining their budgets.

Developing a legal theory that would fairly treat the tobacco industry, the taxpayers of the state, and the smoker is the primary challenge in trying to redress the enormous strain on our health delivery system that is caused by tobacco. The traditional tort system was designed to redress the balance between the manufacturer and the consumer of a product. Product liability law, negligence law, and other such legal theories are based on the relationship between manufacturer and consumer. However, in the case of tobacco, the contest is not so much between the manufacturer and the consumer, but between the third-party taxpayers who must pay for the enterprise between the manufacturer and the consumer.

Is it fair to have the taxpayers stand in the shoes of the smoker, as in a traditional subrogation case? Medicaid, in many ways, is like insurance. It is not insurance in the traditional sense, because the insurer cannot calculate a fee and assume a risk for a fee by contract. But, nevertheless, it is not subrogation; it is not the traditional insurance relationship because states and governments must treat their indigent sick. They have no choice but to do that. They cannot decline coverage or the right of policy. They must treat these people. They cannot let them die in the street, regardless of whether they smoke, drink or lead other risky lifestyles.

In this light, what kind of legal theory properly redresses that balance, where the relationship of manufacturer and smoker is causing a public health crisis? We labored mightily to come up with legal theories that would do that. What we did was resort to some very traditional legal theories that have been part of Anglo-American jurisprudence for many centuries: equitable theories of restitution, indemnity, quasi-contract and public nuisance. While other theories that some of the states are using are based on consumer fraud[6] and antitrust,[7] all the states have, as the basis

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5. *See* Peter T. Kilborn, *Welfare All over the Map*, N.Y. TIMES, Dec. 8, 1996, at E3.

6. *See* State v. Philip Morris Inc., 551 N.W.2d 490, 495-97 (Minn. 1996) (alleging that Philip Morris violated consumer protection statutes relating to consumer fraud); *see also* Karen E. Meade, *Breaking Through the Tobacco Industry's Smoke Screen: State Lawsuits for Reimbursement of Medical Expenses*, 17 J. LEGAL MED. 113, 125 & n.147 (1996).

7. *See Philip Morris Inc.*, 551 N.W.2d at 495-96 (affirming a ruling that plaintiffs have standing to pursue a claim against Philip Morris on grounds of statutory and common law antitrust claims); *see also* Barnaby J. Feder, *Texas Joins Other States in*

of their cases against the tobacco industry, used these equitable theories. Despite these theories, the tobacco industry is not defenseless. It can show that the state has unclean hands, that the state participated in the activity by licensing it and receiving tax revenues from it. However, the equitable theories do prelude the tobacco industry from setting up the smoker's own conduct as a defense, because it is the relationship between the smoker and the tobacco industry that caused the problem.

Another defense that has been raised by tobacco companies is "the early death defense,"[8] which is essentially an economic defense. The tobacco industry claims that smokers die an average of eight years earlier than non-smokers and, therefore, it saves society the cost of pension and geriatric care and various other expenses.[9] As a matter of law, that defense does not lie, but it becomes absurd when taken to its logical consequence. Suppose a driver kills a ten-year-old. Before the child dies, he lingers on for a month in the hospital and runs up a bill of thirty or forty thousand dollars. When sued by the parents of the child, the driver defends by claiming that, had the child lived to be seventy-five years old, his hospital bills would have been far in excess of thirty or forty thousand dollars; therefore, the parents owe the driver money. The driver files a counter-claim because he saved the parents money. So the principle applies to tobacco litigation: killing people early is not an acceptable defense to liability.

Another favorite defense of the tobacco industry is the "unclean hands" defense mentioned earlier: states make money taxing tobacco.[10] Of course states make money taxing tobacco; yet they make money taxing everyone for a variety of things, such as income and excise taxes. Tobacco is not the only product that is subject to an excise tax, but it is the only product with a body count. The fact that tobacco generates money for state government is no different from the fact that anyone's taxes go to support the federal government, as well as state and local governments. Such tax monies are not earmarked for a particular disease or for health care but are for the general conduct of government.

Taxes, quite simply, are not a damage deposit against which one can injure the state to the extent one has paid taxes. And, in the case of tobacco, the tobacco industry itself does not ever pay excise and sales taxes: one hundred percent of those taxes is passed directly to the consumer through price mark-ups. To begin with, the amounts of such

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Suing Tobacco Industry, N.Y. TIMES, Mar. 29, 1996, at B9.

8. *See* Peter Huber, *Whose Gore Is Stalked?*, 41 N.Y.L. SCH. L. REV. 419 (1997).

9. *See* Gangarosa et al., *supra* note 3, at 85 n.19.

10. *See* Laura Manserus, *Tobacco on Trial: Making a Case for Death*, N.Y. TIMES, May 5, 1996, § 4, at 1.

taxes are woefully insufficient to compensate for all the sickness and death that cigarettes cause.

The tobacco industry is also seeking to use the creation of economic activity as a defense.[11] Their argument is that the process of manufacturing and selling tobacco products generates jobs, income, salaries and sales quite separate and apart from taxes and, therefore, if the tobacco industry goes bankrupt, all that economic activity will be lost. The industry is fond of claiming every convenience store clerk is a tobacco job and they will talk about the tobacco industry in every state in the country. Frankly, the "tobacco industry" is only in about five or six states in our country, and there is no significant tobacco growing outside those five or six states.

The claim that all these jobs and all this economic activity would be lost if tobacco disappeared sounds appealing. But, would we really lose all this economic activity? No, we would not. If people did not smoke, if tobacco ceased to be sold today and people quit smoking today, the money they spend on tobacco products would not go out of the economy. The sixty or seventy dollars per month that a smoker spends on cigarettes would not be thrown away. People would buy something else with it. People would invest it. All the money would stay in circulation. No net loss would occur if tobacco completely disappeared. And, more importantly, most of tobacco's economic activity is really an export of currency from the non-tobacco states to the tobacco states. For example, in Michigan, about one dollar out of every two is exported from the states that do not grow tobacco to states that do.[12] A number of studies have documented that no economic benefit arises from the tobacco industry outside the five or six states that grow tobacco.[13]

Lately, some have advocated a legislative solution to resolve this immense problem because the class action solution is not available.[14] The class action is too complicated, and there are too many disparate claims and disparate interests for a class action to resolve this. After the

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11. *See* David Greising et al., *Does Tobacco Pay Its Way*, BUS. WK., Feb. 19, 1966, at 89 ("In the case brought by Mississippi . . . tobacco industry lawyers have laid the ground for a defense based on the economics of tobacco."); *see also* Scott Richardson, Note, *Attorney General's Warning: Legislation May Now be Hazardous to Tobacco Companies' Health*, 28 AKRON L. REV. 291, 330-31 & n.341 (1995).

12. *See* Kenneth E. Warner et al., *Employment Implications of Declining Tobacco Product Sales for the Regional Economies of the United States*, 275 JAMA 1241 (1996).

13. *See* Richardson, *supra* note 11, at 331 n.341.

14. *See generally id.*

recent decisions in *Georgine v. Amchem Products, Inc.*[15] and *Castano v. American Tobacco Co.*,[16] the class action vehicle for resolving the tobacco issue is no longer on the table. As a result, a number of us, including some of the attorneys general and many in the public health community, have embarked upon a potential legislative solution that will resolve this enormous social problem. A number of issues exist that must be addressed in any sort of solution like that. One of them is youth smoking.

The Food and Drug Administration issued rules and regulations that would restrict the advertising of tobacco products to ways that would not appeal to youth.[17] That is not an insignificant problem, and it has to be part of any solution—stopping any sort of appeal to youth. More than eighty percent of all youth smokers are eighteen or under; yet the tobacco industry likes to say the government is trying to make restrictions on the sale of a legal product. Well, it's not legal if you're under eighteen and that's where all the new smokers come from.[18] Less than ten percent of smokers start smoking after age twenty,[19] so these restrictions have got to be put on youth smoking.

Other issues exist as well: What to do about existing lawsuits? What kind of compensation system can be set up for existing smokers? How much should and can the tobacco industry pay to compensate sick smokers and compensate the states and the federal government for the enormous amount of money they are spending to treat tobacco-related illnesses? All

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15. 83 F.3d 610 (3rd Cir. 1996) (denying class certification in proposed class action against manufacturers of asbestos-containing products), *cert. granted sum nom.* Amchem Prods., Inc., v. Windsor, 117 S. Ct. 379 (1996).

16. 84 F.3d 734 (5th Cir. 1996) (reversing certification of class consisting of all nicotine-dependent persons in the country who have purchased and smoked cigarettes manufactured by tobacco companies).

17. *See* Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect Children and Adolescents, 61 Fed. Reg. 44,396 (1996) (to be codified at 21 C.F.R. §§ 801, 803, 804, 807, 820, 897); *see also* Joseph R. DiFranza et al., *RJR Nabisco's Cartoon Camel Promotes Camel Cigarettes to Children*, 266 JAMA 3, 149 (1991); Jeffrey Goldberg, *Next Target: Nicotine*, N.Y. TIMES, Aug. 4, 1996, § 6 (Magazine), at 22; Peter T. Kilborn, *Clinton Approves a Series of Curbs on Cigarette Ads*, N.Y. TIMES, Aug. 24, 1996, at A1.

18. *See* Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect Children and Adolescents, 61 Fed. Reg. at 44,396. *See generally* DiFranza et al., *supra* note 17; Paul M. Fisher et al., *Brand Logo Recognition by Children Aged 3 to 6 Years*, 266 JAMA 3, 145 (1991); John P. Pierce et al., *Does Tobacco Advertising Target Young People to Start Smoking?*, 266 JAMA 3154 (1991).

19. *See* Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect Children and Adolescents, 61 Fed. Reg. at 44,398. *See generally* DiFranza et al., *supra* note 17; Fisher et al., *supra* note 18.

of these are very difficult issues. The tobacco industry has done a considerable amount of research on the behavioral and health effects of tobacco products.[20] What about that research? Can it be made public? Should it be made public? Should the public be better informed about the nature of nicotine and the addictive qualities of nicotine? What does the tobacco industry really think about nicotine? What do their own test results show? Not all of these studies are in the public domain, although a few of them have started surfacing lately.[21] But what the tobacco industry knows and what the public knows about nicotine and its pharmacological effects needs to be addressed for any sort of solution.

I think we are going to proceed along that path and, hopefully, there will be some legislative solution to the tobacco problem. If it is not worked out, I fear that it will continue to be a race to the courthouse by a number of states who are seeking to get their money from the tobacco industry, and the claims by these states are in the billions of dollars. As big as the tobacco industry is, and as wealthy as they are, they cannot respond to claims that big if they lose. Consequently, if one or two of these states wins its lawsuit, it is going to be a bankruptcy situation for the tobacco industry. There will be no alternative. This does not even consider what happens to stock prices. Bankruptcy would be a bad solution because nobody wins. In my opinion, it is the "Court of Bad News."

To conclude, I hope that we will be able to come up with a legislative solution to the tobacco problem. It will not be something that everyone will like, but it will ideally fit the definition of a good compromise—something that is equally satisfactory for everyone.

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20. *See* Philip J. Hilts & Glenn Collins, *Records Show Philip Morris Studied Influence of Nicotine*, N.Y. TIMES, June 8, 1995, at A1; *Tobacco Studies Detailed*, N.Y. TIMES, July 25, 1995, at C7.

21. *See* Glenn Collins, *Group Seeks a Reopening of Hearings on Tobacco*, N.Y. TIMES, June 14, 1995, at A16; *Tobacco Memo Advised Burying Adverse Study*, N.Y. TIMES, Sept. 19, 1996, at A21; *University to Display Tobacco Documents*, N.Y. TIMES, July 4, 1995, at A9.

SUBROGATION AND INSURANCE, WITH ESPECIAL REFERENCE TO THE TOBACCO LITIGATION

RICHARD A. EPSTEIN, THIRD PANELIST*

I must confess that Mr. Scruggs's presentation absolutely blew my mind away. It was a virtuoso performance from which I have learned the new definition of fairness. Fairness is a one-way transfer of wealth from those who pay to those who receive it. But first a disclaimer. I have worked with Philip Morris on a variety of tobacco cases for a long period of time. When I appeared on this panel I was not planning to speak about this topic. In light of what has been said, I will go on with my general remarks, some of which do cover this issue of subrogation. I will steer away, at least for the beginning, from the actual controversies that beset us and concentrate on remarks that address the role of third-party insurance for the defendant, before addressing the now controversial questions of subrogation, which involve claims against a plaintiff by his insurers.

In thinking of the two-party suit, the first question we ask ourselves concerns the position of the defendant in the lawsuit. Normally when liability rules are crafted, the standard common law methodology first requires us to figure out the merits of the underlying case. When that is done, the defendant then figures out its exposures under the applicable law. Collective decisions about liability are made first; thereafter private decisions about insurance follow. The insurance company will supply the defendant with services, such as the defense obligation, and various kinds of coverages. The theory is that the service obligation will be supplied at lower cost and greater reliability when it is tied to the provision of insurance than would otherwise be the case. The basic coverage obligation in turn insulates the firm from the real downside that comes from large hits. Essentially, insurance normalizes and equalizes the flow of expected returns over future periods. One consequence, perhaps unintended, of insurance is that it could easily influence the way in which courts and juries think about underlying liability issues. Once judges and plaintiffs' lawyers understand that insurance is available, they will use it as a reason to increase the scope of liability. The traditional relationship now works in reverse. First the insurance coverage is understood, and then the liability is expanded in response. The presence of insurance expands the class of insurable wrongs.

The role of insurance in shaping liability is a serious question, but it covers only one side of the relationship. Equally important is the symmetrical issue for plaintiffs. It is not only defendants who can get

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insurance, but also plaintiffs. Sometimes, as we just learned, that insurance comes in the form of Medicare and Medicaid. What typically happens, for example, is that the patient of a physician who is faced with certain kinds of risks asks himself what kinds of protections he would want against those risks. Generally, most people understand that there is a diminishing marginal rate of utility to money. At the same time, they are very worried about certain kinds of adverse consequences, and they are willing to take some of the money that they would have had at their disposal in good times and to put it aside so that it will be available for use in bad times. So they buy health insurance to try to maximize their expected utility over all anticipated states of the world for all future periods. The incentives here are similar to those that guide the defendants in their decisions to purchase liability insurance.

First-party insurance over all its lines is a big industry. It is probably bigger than the liability lines of coverage when property damage, including that from catastrophic losses—hurricanes, tornadoes, floods—are taken into account, along with disability and health insurance. By any standard this is not a trivial part of the market. The thorniest legal problems arise at the intersection of this first-party market with the third-party liability market. That overlap arises because many of the people who are insured under various public and private programs also lead dual lives as tort plaintiffs. The puzzle, or the squabble, then, crystallizes over the prospect of overinsurance. More concretely, what happens when two sources of recovery are available to an injured person, one from the first-party insurance company and the second from the particular tort defendant and its insurer, if any.

The mechanics of this relationship have proved very difficult to work out. The controversy is less concerned with poverty, and more concerned with apparent abundance. When viewing the situation at the back or "wrong" end—that is, ex post—how many people would, by virtue of being injured and getting full compensation from a tort defendant *and* medical expenses from a first-party insured, feel they are now "better off" than if they had never been injured before? The answer is in a sense paradoxical. Most people would rather never be injured, even if they had to forego benefit from a dual recovery. But at the same time, the relevant question is whether they would, before the accident took place, choose to indulge at their own expense in a system that promised them this double recovery. The evidence from contracting behavior seems pretty clear. Most people do not want to pay for double coverage of this sort. Since they do not want to throw away the more substantial tort remedy when it is available, they often strike deals in which they forgo the first-party insurance that they would otherwise be entitled to receive. Since tort payouts often take longer to obtain than first-party coverages, the deals become a bit more complicated. The individual gets his first party insurance pending the outcome of the tort litigation. If that proves

successful, then it is under a duty to reimburse the first-party health insurer for all or some predetermined portion of the medical expenses that have already been paid out on his behalf. So a large cottage industry develops to determine the conditions under which that reimbursement is required. Thus the law of subrogation is born.

The scope of these arrangements is, moreover, not limited to reimbursement after the tort recovery is obtained. Equally important are decisions that determine the pattern of behavior prior to any tort recovery. Does the injured individual or first-party insurer control the suit? Do they split authority, and if so how? Who gets what kind of priority over the recovered money. Recall that the ordinary tort suit involves pain and suffering, which is normally not compensable by first-party insurance. It also involves lost earnings which may be offset by disability insurance. And finally, it covers the medical expenses, which are typically the object of health insurance. Generally speaking there is no case for having the first-party insurer recover for pain and suffering, which it did not bear. But on the other hand, two items dividing the proceeds is more difficult. Sorting out the nature of the recovery is a hard task to do in the abstract. It seems that the right approach to this knotty problem is to let the two parties—the subrogee, as it is sometimes called, and the victim—work out between themselves a particular agreement that deals with each and every portion of the tort recovery. And just that is done in many cases.

I can predict what the priorities in distribution would look like. For the most part, it would end up with the insurance company getting back its money first, not because it is the dominant and more powerful party—that is not an argument that works well in competitive markets—but, rather, because from an ex-ante perspective, people are generally more concerned with their out-of-pocket expenses than they are with their pain and suffering. They are trying to control their out-of-pocket expenses, and if they can reduce the front-end rates associated with obtaining a given level of health coverage, generally speaking, they will be prepared to sacrifice double recovery in a few cases for lower rates across the board.

Once a case goes into litigation, however, one's view of the merits and the justness and, I dare say, the "fairness" of the subrogation rules starts to differ, as Mr. Scruggs's presentation makes all too evident. Injured parties have peeked around the veil of ignorance, and they now endorse state intervention on noncontractual principles to upset the subrogation arrangement. These meddlesome activities are often disguised as "equitable" remedies that allow persons who enter into contracts on one kind of arrangement to repudiate that deal, and to keep the money that they promised to pay over at the inception of the arrangement. It amounts to treating a contractual obligation as an option not to honor the insurance contract.

I have been involved as a lawyer consultant for subrogees in the breast implant cases. The entire episode was highly instructive because it casts traditional plaintiffs into the role of defendants. Their attitude is that they do not have to worry about obligations under subrogation contracts. They are simply annoyances. The subrogees should not be allowed to enforce their rights as parties to the underlying litigation. The cooperation obligations of the first-party insureds do not count. Disclosures need not be made to prospective plaintiffs that their recoveries may be subject to subrogation obligations. Massive resistance was in fact the order of the day. How unfortunate! In a world which generates enough contention under the tort system—as it exists in terms of controversies between strangers—the only sound principle that one can deal with in these cases, when looking at the plaintiff's side, is to allow the initial agreement to control, both with respect to the control of the litigation and the distribution of the proceeds, whether the money comes through litigation or settlement.

Now, that is the issue that must be resolved between the subrogee and its insured, the plaintiff. But what about their joint position against the defendant? Here the main objective of these two parties, as plaintiffs, is cooperation that allows them to achieve a jointly favorable outcome against the defendant whether by litigation or settlement. In order to do that they must reduce their costs in order to maximize the potential gain. And if they fail to do so the entire litigation could easily founder on the rocks of internal conflict.

So far we are dealing with the usual matter of tactics and strategy which assume that the defenses legally available to the defendant are neither increased nor reduced by any agreement that the subrogee reaches with its insured. If I were to live in subrogee heaven, however, I should like very much to eliminate that restriction with the stroke of a pen. I would therefore be very eager to enter into a contract with my insured which goes something like this: "In the event that you get injured, I may sue the other party, and any defense that he has against you he will not have against me." In this way, I can recover everything from him and not have to worry about meddlesome defenses like preemption, contributory negligence or assumption of risk.

Achieving that position is the closest that any lawyer could come to the alchemist's dream of turning dross into gold. And that precisely is Mr. Scruggs's position.[1] What happens, as he says, is that governments, both state and federal, have proved utterly incapable of administering and controlling their Medicare and Medicaid budgets. Yet the question of direct reform is painful and is sure to counter political resistance from

1. *See* Richard F. Scruggs, *Tobacco Litigation: A Problem that Needs a Solution*, 41 N.Y.L. SCH. L. REV. 487 (1997).

well-oiled interest groups that profit from the continued downward spiral of these programs. But there is a light at the end of the tunnel. The more inept the management of these programs, the more substantial the recoveries they should obtain from the tobacco companies for tobacco-related illnesses. They achieve this winsome result by persuading state legislatures or state courts that their subrogation agreements with their patient base should read: "We will pay your medical expenses on the condition that none of those meddlesome defenses that could have been asserted against you can be asserted against us."

I am going to have to make a confession now. I studied legal history at Oxford. I am one of the few people who actually teaches Roman law. To describe Mr. Scruggs's position on tobacco as "revisionist" of the established legal position would be, I think, to flatter it unduly. I think one can look through the length and breadth of the common law and the civil law and find it utterly barren of any indication that the assignment of a claim from *A* to *B* allows *B* to ignore contractual defenses that *C* could assert against *A*. The basic common law rule has always been (both in law and in equity, for on this point "equity follows the law,") that an assignee always takes subject to defenses. And surely it could never be otherwise if the alchemist's dream is to be foiled. Worried about the statute of limitations, a setoff, a breach of condition, a statutory defense, no matter. Sell the claim to the right third party and these defenses will all vanish. The risk of strategic behavior between plaintiffs and subrogees is so manifest that I am not aware of any precedent in any court, statute, or treatise, which countenances this brash maneuver. The legal theory, such as it is, depends on the fertile imagination of Mr. Scruggs and one of his most distinguished legal advisors, Professor Laurence Tribe. It has no known origins anywhere else.

Mr. Scruggs must recognize that the basic tidal wave of precedent is against him, so he has to work hard to explain why his case is distinctive. And he claims that the state is under a legal obligation to supply medical care and thus should not be treated as a "mere volunteer." But this argument surely fails. The first point is that the "mere volunteer" rule makes eminently good sense. It cannot be the case that *A* can recover a fortune from *B* by first paying for *C*'s medical bills. What *A* gets from *B*, what the state gets from its Medicare and Medicaid patients, is an assignment of their causes of action against the tobacco companies, which in turn are subject to defenses, just as the traditional law of subrogation provides.

But it will then be said that Medicare and Medicaid are different because federal obligations mandate that states expend their resources to counteract the harmful effects of smoking. So states are not mere volunteers after all. Rather they are acting under some external obligation. But again the argument misses the point. The obligation in this case is imposed by a third party, the United States government. As

such, it takes the form of another unfunded mandate. Surely the right answer is for the states and the federal government to work their disagreements out between themselves. It is not to export them onto tort defendants. The remedy for the state is to insist that federal revenues be used to fund the discharge of state obligations. It creates far too much risk of collusive behavior between state and federal government to allow the federal compulsion of state action to create remedies against individual defendants that would otherwise not exist. That rule would be regarded as virtually self-evident in contexts apart from tobacco. It seems as though it should be regarded as self-evident in this context as well. If *A* and *B* by contract cannot impose obligations on *C*, then *A* by command to *B* cannot unilaterally impose obligations on *C* either.

All this is not to say that Medicare and Medicaid can do nothing to control expenses. Consider, for example, these points. Presently the Medicare and Medicaid programs make no provision for differential premiums for smokers and nonsmokers. But there is no reason in principle why both governments could not, if they so choose, charge differential premiums for smokers to cover their increased risk of various types of covered illnesses. That approach would create incentives to reduce the level of smoking, and it also would reduce any implicit subsidy that nonsmokers are forced to pay for the benefit of smokers. But that solution has thus far fallen on deaf ears. Yet it is one that is commonly followed by private insurers that take smoking into account in their underwriting practices. It could, and perhaps should, be done here.

No matter how one thinks about the matter, therefore, the one fixed piece of the legal environment is the traditional rule that requires subrogees to take subject to defenses against their subrogors. That rule was traditionally respected in all Medicare and Medicaid contexts which required subrogation from recipients, but did not, as the recent wave of lawsuits have tried to do, circumvent that requirement.

That in turn brings us back to why it is so imperative for Mr. Scruggs to do an end-run around established law. The individual lawsuits have foundered on a mix of causation and assumption of risk defenses (not to mention preemption) that have a sturdiness before juries not appreciated by the popular press. The ambiguity on causation is one that is deep in the law. Does it mean that if something is done (a blow to the skull) then something else necessarily follows (death), which otherwise would not have happened before. Is the world one, where the probability of death without the defendant's act is zero, but with it becomes one—a strictly deterministic universe. Recent theoretical developments in causation have suggested that very few cases fit into this strong push/pull, on/off category. Rather most cases of causation often contain probabilistic assertion, such that the occurrence of defendant's action (the discharge of toxins) increases the risk or hazard of injury to the plaintiff. No longer

do we have the on/off category. Rather, we have a higher probability of harm conditional upon the defendant's action than without it.

Smoking surely fits into this increased risk or hazard category. But once that becomes the relevant causal argument, then it makes far more plausible the assumption of risk defenses, which when all is done say that some people are prepared to assume an increased risk or hazard in order to obtain some other benefit or pleasure which they regard as of equal or greater value. In this calculation it surely helps the tobacco companies that nicotine is a generic constant whose chemical and psychological characteristics have been well ventilated in the popular press and medical literature for years. It becomes credible therefore to insist that these risks are of common knowledge so that they are assumed by individuals who choose to smoke. And it strengthens that case that many who choose to smoke also choose to vary the quantity of cigarettes they consume, the type of cigarettes they consume, and in many instances to quit altogether. The aggregate pattern of behavior looks as though as the perceived price of smoking increases the level of consumption goes down. Putting all this information together in concentrated form amounts to a formidable defense that has thus far persuaded most juries and most courts, regardless of their sympathies to the tobacco industry. Yet the new lawsuits by avoiding the typical subrogation requirements utterly eviscerate the core of the available defenses.

So what should be done? People can decide to stop smoking. Or, the government can decide that it is not going to provide smokers with this kind of insurance without making the needed risk adjustments. The government can impose a tax and then simply say that it will not go into general revenues, but it will have to be sufficient to cover the number of smoking-related illnesses. The government might even, God forbid, decide that it is going to ban tobacco on the grounds that the external costs are not worth it. But, the one alternative that is absolutely unacceptable is precisely the one that Mr. Scruggs pronounces as "fair." As Mr. Scruggs has put the proposition to us, first, we play the game under the conventional rules, and now that we have had a history of fifty years, we will retroactively impose a system of liability—which nobody dreamed of. We are tempted to call this new-found invention more ancient than Methuselah, and thus cloak our inventiveness in the veil of history.

And I thought that tort litigation was approaching some level of parity, fairness, and balanced playing fields. But what some now want to do is redefine the playing field so that somebody who comes in, technically, as an assignee, now has an independent claim. What the government is constitutionally able to do on this world-view is pass legislation that says the tobacco companies owe it *X* billion dollars. That

is basically what is happening. Years ago, when I wrote *Takings*,[2] I claimed that anytime liability rules are modified, anytime land use regulations are imposed, anytime new taxation is imposed, there has been a taking, and the issue that remains to be settled is either that of state-justification or state-compensation. Little did I know how true that was until I heard the proposals Mr. Scruggs now advocates. What makes it worse, in constitutional terms, is that the state is an interested party, and the state is preparing legislation that will grease the skids to its greater success. So what really makes me absolutely irate is the thought that somehow, the way that the public can win this dispute is for interested citizens to vote in a legislature that they conveniently control a claim to the cash that they wish to have.

In this sorry state of affairs, it seems to me that not only do we have takings issues, but we have rather rudimentary concerns of procedural due process, where an interested party is trying to pretend it is some sort of dispassionate individual. I have encountered more than a few unmeritorious lawsuits, but few as unmeritorious as this one. Indeed I think that the popularity of this present technique stands in inverse relationship to its intellectual coherence and strength. In principle, I do not understand how one could put this idea forward with a straight face. Perhaps three hundred billion dollars offers three hundred billion reasons to persuade me to think otherwise.

2. *See* RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN (1985).

PROSECUTION OF INSURANCE FRAUD IN PHILADELPHIA— A NEW PARADIGM

THE HONORABLE LYNNE ABRAHAM, FOURTH PANELIST*

Had I known that the Federalist Society was not a stuffy group of intellectual giants, but was, instead, a convivial and jovial assemblage of great mental giants, I would have come here much earlier. I am exceedingly grateful to the society for inviting me to participate. I fear that Mr. Epstein is a very difficult act to follow.

I am delighted to be here to give you my view of what prosecutors can do in the civil field, and I have been asked specifically to talk about my assessment of insurance fraud and the "crisis" that it has become.

First, prosecutors do, in fact, use civil law and civil litigation. My office, in particular, has used civil litigation and civil law in our nuisance pursuits. For example, we seek to close nuisance establishments by use of civil litigation, and we use civil asset forfeiture. Of course, we apply for injunctive relief. And certainly, in the field of legislation, we have actively and consistently lobbied for changes in a variety of contexts that affect civil law. Most notably, but not exclusively, we lobbied for the Prison Litigation Reform Act,[1] which Congress just passed in 1995.

I would like to start with some concrete examples of insurance and disability fraud that we prosecutors have pursued. The first is a story that got everybody's attention, at least in Philadelphia. The Southeastern Pennsylvania Transportation Authority, in an attempt to test its emergency preparedness, staged an accident with an empty and out-of-service train. Ambulances were summoned to the scene, sirens blazing, lights flashing, police vehicles were there, and a variety of assorted actors and actresses were dutifully strapped to boards, put in various braces and restraints and were "carted off" to the hospital, to show how quickly ambulances could respond, how well the police would handle the situation, and what the driver would do.[2] Whereupon, a woman came upon the scene, having nothing to do with the staged performance, and walked up to an officer and said, "Officer, I was on that train. My neck is killing me. Would you please see to it that I am taken to a hospital right away."

The officer, not missing a beat, said, "Yes, ma'am. I'm going to get you a board. I want you to sit down right here." She was dutifully strapped to the board. Everybody was in on it except for the unfortunate

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1. 18 U.S.C.S. § 3626 (1996).

2. *See* Rita Giordano, *Woman Gets Jail in SEPTA Fraud*, PHILA. INQUIRER, Nov. 29, 1995, at B5.

woman. She was taken to the hospital, where she complained of extraordinary pain and terrible soft tissue injury. None of it, of course, could be verified on x-rays or examination because it was non-existent. She is now comfortably in Sconston, a prison, serving her sentence.[3]

Another incident involved a city employee of some duration who had taken a frolic of his own at lunch, went to a local oyster house, "slipped on catsup," and feigned a disability. He sought, and received I might add, a total disability for life, because at one point during his lunch he discussed city business. When he was caught on film doing all kinds of things that a disability would not allow for, he was, of course, properly denied his money, and he is being prosecuted, as well.[4]

More seriously, a woman had the misfortune of allowing an intruder into her house in South Philadelphia. The intruder first knocked on the door but, ultimately, forced his way into the house and shot her twice in the head in full view of her children. It later turned out that this woman had been subpoenaed to appear before a federal grand jury the very next day to give testimony about an attorney who had conducted a large scale series of fraudulent claims against insurance companies. The attorney is now serving a life sentence in a federal prison for the contract killing of this grand jury witness.[5]

As a last example, in D.C., a case is now pending where a gentleman believed that his fiance had taken out an insurance policy naming him beneficiary, so he managed to have her killed in anticipation of receiving the insurance proceeds. It turned out that she had not yet made him the beneficiary of the policy.[6] He made a little mistake: bad timing.

These examples involving frauds cover things that interest the prosecutors and, up until very recently, at least in Pennsylvania, were unavailable to be redressed other than through investigation and denial of the claim.

While insurance companies were certainly ready, willing, and able to deny coverage to a party on allegations of insurance fraud, without prosecutorial teeth the insurance company was left to shake its finger at the offending person or persons, lawyers, physicians, and others, and then deny coverage. However, the culprits were still allowed to go off onto the next case, where perhaps their efforts would be more fully rewarded.

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3. *See id.*

4. *See* Robin Clark, *Did City Pension Board Slip Up?*, PHILA. INQUIRER, Nov. 26, 1991, at B1.

5. *See* United States v. Burke, No. 92-00268-01, 1992 WL 333578 (E.D. Pa. Nov. 6, 1992), *aff'd*, 31 F.3d 1174 (3d Cir. 1994), *cert. denied*, 513 U.S. 1110 (1995).

6. *See* Arlo Wagner, *Killing Linked to Insurance Policy*, WASH. TIMES, Jan. 31, 1996, at B1.

Workers compensation fraud; arson, whether real or bogus, of boats, buildings and other things; auto theft, whether prearranged to avoid paying further monthly payments to a bank or some company; staged accidents; and health care fraud have now become a one hundred billion dollars a year industry involving ambulances, labs, hospitals, doctors, tests, false billing, kickbacks, unapproved devices, and unlicensed personnel. It is obviously of interest to prosecutors all over this country.

In Pennsylvania, especially in Philadelphia, our problems are particularly acute, where for every one hundred accidents there are seventy-five bodily injury claims, many of which are totally bogus. And, since pain and suffering is the way we assess how much damages a person is really going to get—it is a reimbursement of expenses plus a multiple for pain and suffering—multiple meds always encourage exacerbation and exaggeration of claims, as does, of course, the health care industry. It is estimated that in Philadelphia alone three hundred million dollars a year in phoney claims are submitted for collection.[7] And, to make matters worse, half of the drivers in Philadelphia have no license at all, so we have unlicensed, uninsured motorists. Thus, in Philadelphia, if you are in an automobile accident, you have a one-in-two chance that the other person is neither licensed nor insured. And, because the value of the assets of the party at fault is zip minus a million, guess who is going to be sued? Not the zip minus a million. You, the person, who, hapless though you might be, has insurance coverage.

Only those who have assets to protect are going to get insurance, not the person who has really nothing to protect, and traditional legal mechanisms have not proved appropriate merely because the person without insurance can be sued. He has nothing against which to register the judgment except his name, which is useless. Sometimes, the car is not worth the insurance premium that is attached to it. Fines through other traditional means have been uncollectible, and, besides, the value of the car is worth less and the cost of insurance is worth more, so the possibility of an assessment of fine is really no deterrent at all.

Enter District Attorney Lynne Abraham, who said the insurance companies, as well as the City of Philadelphia—which always complains about people who do not remit appropriate funds to the coffers of the City of Philadelphia, but are unwilling to staff a district attorney to try to collect them through a variety of means—suffer the same fate. As a result of legislative efforts, the Commonwealth of Pennsylvania legislature created, two years ago, an Insurance Fraud Prevention Authority,[8] as well

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7. *See* David I. Turner, *8 Charged with Insurance Fraud*, PHILA. INQUIRER, Jan. 25, 1996, at B13.

8. *See* Insurance Fraud Prevention Act, 40 PA. CONS. STAT. ANN. § 3701-301 (West 1995).

as an Automobile Theft Prevention Authority.[9] The insurance fraud covers every kind of insurance, from apples to zinc.

As a result of these two enactments, a real change in prosecution efforts has occurred. Not only has my office, in a task force fashion, joined federal prosecutors to prosecute all kinds of fraud, from health care to anything else that is covered by federal statute, but we have also begun our own insurance fraud unit, which has approximately twenty-five total staff members—ten detectives, six lawyers, and the rest support staff.

Now, criminal referrals by insurance companies carry certain risks, and there are certain benefits. Obviously, when coverage is denied, bad faith is always claimed by the insured. Also, claims are delayed significantly in their capacity or ability to be resolved.

There may be, and frequently are, requests for stays of civil proceedings pending the disposition of the criminal case. Also, the insurance company loses control because prosecutors will never allow insurance companies to dictate prosecutorial policy. This is not a case for quick settlement where we assess the risks and the benefits; this is a prosecutorial criminal case, which the insurance company has no control over, and, obviously, we control the flow of information, not the other way around.

But there are many benefits, some of which have been spoken of previously, some of which have been found in the materials that are easily accessible to this group, and they are the following, but in no particular order of importance: Referrals for criminal prosecution, as opposed to the typical civil solutions, are the best opportunity for a company to make a financial recovery. There are better investigative efforts, and we utilize the investigative efforts of insurance companies to find out what really happened. We not only use our own criminal capacities, which are unavailable to insurance companies—for example, court-ordered wiretap and electronic surveillance—but, obviously, we make insurance companies do better work, because if we are going to take a case, we want to make sure they are doing their best efforts, not their far-from-best efforts. We also, of course, recognize that parallel civil suits may be filed. So there is both a civil and a criminal opportunity for resolution. There is also the possibility of asset forfeiture, civil *in rem*, and criminal *in personam* proceedings.

Furthermore, the convict, if convicted, is obviously faced with the possibility, especially in federal litigation, of being estopped from denying in a civil action that any offense ever occurred. Also, the defendant is forced into a position of recognizing that if they are in serious peril of

9. *See* Automobile Theft Prevention Act, 40 PA. CONS. STAT. ANN. § 3601 (West 1995).

criminal prosecution, state or federal, they should disgorge profits and make restitution early in order to avoid a harsher penalty.

In any event, it does force a defendant to make restitution early in order to avoid penalties, and there is nothing better than going before a jurist at the time of sentencing and saying, "Your Honor, I have recognized the error of my ways, and I have given the insurance company all this money and more, so please consider that in sentencing."

Finally, and perhaps most importantly, there is a great deterrent value. When I went before the plaintiffs' bar and told them, guess what, we have an insurance fraud authority, it was like asking, "Do you want the rack or the whirlpool? Pick your poison." There was great wailing and gnashing of teeth, and I said, "Listen, you will find that in six months time, no later, we will be your newest best friend, because we are not interested in prosecuting attorneys. What we are interested in is deterring attorneys from considering taking any case which has that faint, but unmistakable, odor of fraud, which gets stronger and stronger the closer one digs."

It also does have a deterrent effect when people know that these companies are strong proponents of referring cases to a prosecutor. No insurance company is compelled to refer cases to us. It is voluntary on their part. But, it seems to me that insurance companies do know when prosecutorial efforts are available to them. Additionally, people are less likely to attempt fraud when they know that we are watching and that we have resources available to us not available to insurance companies. So I think they really have second thoughts about it.

I think that this is something that really needs to be taken seriously by everybody. While we applaud the efforts of civil litigation and think it is a very important thing for consumers, this is a consumer issue for us, and a fortuitous happenstance that we are in a position to prosecute insurance fraud, the engine that drives so many of the rip-offs in every state of this union.

QUESTION: I was wondering if any of you have any views about the use of social science surveys to determine the prospective size of the pots that damages would be paid out of in these class action suits.

PROFESSOR RICHARD EPSTEIN: Yes. The problem in these cases is to ask whether we can get an accurate reading from some small sample of cases that will tell us the distribution of outcomes in the larger pool. The difficulty of this mission—and it is one revealed in the asbestos cases—is that it is often difficult to figure out how to get the representative sample.

One possible technique is for one party to identify a series of cases to which it then attaches financial evaluations. The other side can then pick from that array of cases those that it wishes to try. If the outcomes are set too high by the first to choose, then the penalty is that a low percentage of the claimed damages will be awarded, and that number could then be used to determine the allowable fraction of each claim within the larger class. So it is another version of the "you cut, I pick" game which seeks to get an honest revaluation of preferences from both sides. But the level of variation in tort damage awards is very high, even when the identical case is tried before multiple juries, and there is always the chance that the damages for a particular case will change over time as the injury or illness progresses. Let a claimant die before the appropriate trial, and all calculations of damages must immediately be revised.

Working this kind of system therefore requires an exquisite attention to detail. I would be reluctant to try it first on a large and complex set of cases, such as those in asbestos, before trying it out somewhere else, perhaps with a set of liquidated damage claims that almost by definition admit to better estimation techniques. Indeed the vastness of the judicial administration question in the asbestos case should lead to still a more profound reexamination of what is going on. What brings all these cases into court under a set of rules that has proved to be so unworkable?

QUESTION: This is for Mr. Scruggs and Professor Epstein. The tobacco discussion today has been educational and frightening. I was wondering two things about the litigation. First of all, if I may mention, the states make, or the states have to give, these benefits. I am wondering why that is, and if it is required by the federal government, then are you really directing your complaint to the federal government or to states' decisions to participate in the programs that lead them down this road to providing these benefits?

And the other thing is—this is more so towards Professor Epstein, but maybe this argument has come up—has anyone in the litigation brought up

a political questions argument that this whole issue is just a legislative matter involving whether these benefits are offered to begin with and that the courts really have no role in it at all?

RICHARD SCRUGGS: The answer to whether states must provide these benefits is, in most cases, yes. States have a compact with their citizens; that is why governments exist. And, one of the major roles of government, although I am sure there are people who would disagree with me, is to provide for the sick and the socially disadvantaged some minimum safety net of social services.

I think the debate today in this country is over where that safety net should be, not whether it should be. States must provide certain health care for indigent people. They have been unable, until presently, to distinguish between smokers and non-smokers. They have to pay regardless of the lifestyle of the indigent.

QUESTION: Do you mean as a matter of constitutional right in their state or as a matter of statutes?

MR. SCRUGGS: It is a matter of constitutional right in our state. I cannot answer for all states, but in our state, we must do that, and we must take advantage of federal programs like Medicaid for the benefit of our citizens. We are a very poor state, and if the government does not take care of our indigent population, they are going to die in the street. And that is not acceptable, at least in my way of thinking about things.

PROFESSOR EPSTEIN: The situation just outlined is simply one where you and I will make a compact that will allow us to impose costs upon third parties. That is quite different from the kind of compact that I regard as potentially viable. Let the citizens who decide to create these universal rights fund them out of general revenues. But once we abandon that constraint and allow retroactive revision of liability rules to hit identified third parties, where do we stop? Why does this principle only apply to tobacco, when it could extend to any other situation in which subrogation is an issue. We only get a respectable political outcome when the same persons who claim the credits from political action are prepared to bear the debits as well. We should never allow government to impose costs on an identified group of individuals or firms by legislation. Externalization of harm leads to resource imbalances whether done by contract or by statute, or by judicial decision. And that of course is the point of the Mississippi scheme. It is an effort to extract revenues earned from activities elsewhere and to funnel them into Mississippi. Oddly enough, Mr. Moore has strong reasons for other states not to imitate his dubious scheme if he could be assured of success acting on his own.

QUESTION: Professor Epstein, I wonder if you would consider the Mississippi-type litigation somewhat less disdained if it was formulated as an alternative to private recovery. That is, are we not actually involved in a choice here between the use of public law or private law?

We were told this morning that class actions, as a means of private recovery, have a number of shortcomings among them: there are excessive attorneys' fees, perverse incentives, and disparate interests. Nonetheless, we undertake these, all in an effort to overcome the quite considerable transaction costs that prevent claimants with relatively minor damages from prosecuting their lawsuits.

So under these circumstances, isn't this the type of situation where we ordinarily would invoke public law, so-called "quasi-criminalization" of certain mass torts, whereby culpable defendants pay fines into the public coffers, and then some administrative process is set up so that claimants with not minor claims are able to lay access to the public coffers as recovery?

PROFESSOR EPSTEIN: Deciding what vehicle is best to litigate mass torts is a vexed question. But with the tobacco claims we should be aware that one of the arguments for amalgamation into class suits is not tenable. We do not deal here with a collection of small claims. The individual damages sought in these actions are those comparable to other actions that are brought individually. The actions are maintainable therefore under ordinary doctrines and procedures.

There are also problems when the emphasis shifts from class actions to administrative remedies, from private to public laws. When I wrote *Takings*, I came to the conclusion that we should be very careful about discontinuities between the private and public law. We did not want to create situations whereby ordinary neighbors could decide to vote for restrictions without compensation when acting alone they would have to purchase restrictive covenants for hard cash. If one group of neighbors could not get an injunction as of right in ordinary litigation, why should they be able to achieve that outcome in the political process? Keeping compensation in the public area where it is required for analogous private actions helps prevent some serious slippage between the two areas.

On this view, the shift from private to public remedies depends not on the reclassification of the right, but on the efficiency of the remedies. Collective action is welcome where disorganized citizens could not organize to bring *valid* legal claims. It is designed not to create a new generation of political rights, but to secure more effective enforcement of rights that are already recognized under the private law.

Whether we speak of tobacco or zoning, it is too easy to conflate the possible justifications for public intervention. Too often legislatures think that the shift to administrative law approaches justifies a new set of rights when all it does is justify a more efficient enforcement of established

rules. The single biggest conceptual mistake of the New Deal is to treat public law as though it is separate and discontinuous from private law. The constant refrain that one hears is that common law baselines do not apply in a public area. The upshot is that politicians write on a blank slate in dealing with legislation, where they can create vast amounts of mischief. In the tobacco litigation, the moral is clear. It may well be that consolidation of claims is appropriate for some efficiency reason. But if it is, the consolidation should not serve as a pretext to eliminate all the substantive defenses that would be available to the defendants against the subrogees if litigation proceeded on a case by case basis. The government subrogees should face the same obstacles as any private charity or commercial insurer. It is the two-step transformation that I so strongly oppose.

QUESTION: I am interested in Mr. Scruggs's response to some of what Mr. Epstein had to say. I am especially interested in the part about things, other than tobacco, coming under the principles laid out.

MR. SCRUGGS: Well, Mr. Epstein just took a page out of Philip Morris's drill book. That is the party line, and he just gave it to you and all of you probably recognize that for what it is.

PROFESSOR EPSTEIN: Is it right or wrong?

MR. SCRUGGS: It is right for Philip Morris; it is wrong for the country. Lawrence Tribe thought a great deal about the legal theories, and, indeed, he did have a hand in these legal theories. This is not something that Mike Moore and I, or Steve Boseman, cooked up. Although, we had a large hand in it, too.

But, let us look at it this way. When one sells a product that, when used as intended, kills four hundred thousand Americans a year; when one laces his product with a substance called nicotine, which is an alkaloid that one's own scientists say is as addictive as cocaine, morphine, or heroin; when one spends six billion dollars a year to advertise that product to kids who are younger than eighteen years old; when one's CEOs go before Congress and state under oath that cigarettes are not harmful, not addictive, and do not cause cancer; when one claims that killing people early is a benefit to society; then it really doesn't matter what legal theory we use. Five billion dollars is not enough.

PROFESSOR EPSTEIN: Wait a second. If that argument is so compelling, you should be able to win individual cases. I have not seen you win them because you have not been able to meet the arguments on the other side.

There are choices; there are risks. People engage in certain forms of behavior. The question we have to face is whether their knowledge is complete or partial. It seems to me that what we have had in individual tort cases is a complex causation argument. It does not take the form, "If you smoke you die." It is a conditional probability. The moment you recognize that account of causation, then you must confront the assumption of risk argument.

Mr. Scruggs's theories, in effect, basically assert that anything plaintiffs can say on their behalf is law and is sacred. Yet anything that defendants can introduce into the litigation is some sort of undue expression that ought to be expunged. It is this utter lack of balance that characterizes your definition of "fairness."

QUESTION: Let me echo out of character and try to ask Professor Epstein a tough question. I think Professor Epstein is as troubled as I am about the retroactivity issue, which just seems to loom over most of the others. In prohibition, we told the rum trust, equivalent of the cigarette industry, that they could not produce their product after a certain date, but it did not bankrupt them based on prospectivity. I think Professor Epstein and I both object to the idea of statutes, like Florida's, that declare retroactively that you owe us money based on your past conduct, and we also object to the development of creative legal theory, which effectively does the same thing.

What you are saying, though, Professor Epstein, is that it is a taking for which compensation mechanisms might be appropriate. Retroactive law, we will soon be finding out as they talk about settling this case, is very much a two-sided street. Legal theories by plaintiffs, which may indeed fly in some state courts, may be cut off under a settlement as a condition of the settlement. And, if I understand you correctly, perhaps they will have a takings claim if one day the supreme court of one or another state, or just the trial court, says, "Yes, cigarette claims are legal from this day on." Five days later, there is some legislative solution. Does every smoker in that state acquire a takings right to get as much as they would have gotten under those five days of law?

PROFESSOR EPSTEIN: This is a genuine baffling question, and a serious one, for it asks how we should handle transitions between legal regimes. That problem is in turn still greater when products, or their effects, only manifest themselves long after the original product has been sold. And with tobacco, as with other products, my first instinct is that products today should be judged, as far as possible, under the basic legal regime under which they were sold. We should follow a consistent legal practice over time.

On this view, if we should decide to change the legal rules, it should be done prospectively—which with a product like cigarettes that has a

continuous distribution is often difficult to do. But let us suppose that the sharp cut can be made, and that cigarettes in the future are sold, even for a period as short as five days, subject to an understanding that smokers who use those cigarettes can recover tort damages without the interposition of an assumption of risk defense. Now I regard that right as vested as well, so that it could only be removed upon payment of just compensation. How much compensation is owed could be difficult to determine. After all, how much harm is done from just five days of smoking? But the basic point is surely correct: once a legal regime, even an unsound legal regime is in place, then its systematic repudiation may well create compensation claims.

Still one caveat has to be entered, for there is some sense to the recurrent concern that every change in the general law not create a right of action. As a matter of construction it may well therefore be preferable to read certain statutes in ways that do not create vested rights. Rather, the statute itself is construed to create rights that are defeasible upon subsequent revision.

With that said, it should be clear that any proposed revision in the tobacco arena that calls for compensation should take certain particular features. The funds in question should be collected at the time of sale, perhaps through excise taxes. And it would probably be necessary to bar the tort actions as a condition for putting the new funding mechanism in place. The new legal regime and the new funding mechanism thus rise and fall together.

Note also that compensation with funding mechanisms are only one alternative. The question I would want to put to Mr. Scruggs is, is he in favor of a flat out ban on cigarettes? I think that it would be a disaster from his point of view because no plaintiff's lawyer ever made money from products that were never sold. Until we decide that we are in favor of the ban, with all the adverse consequences that we create, then it becomes very difficult to act as though we should have banned past sales, which we turn around and treat as wrongful acts. The proposed schemes for retroactive imposition of liability should be regarded as inconsistent with the rule of law.