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# PRESERVING THE COLLATERAL SOURCE RULE: MODERN THEORIES OF TORT LAW AND A PROPOSAL FOR PRACTICAL APPLICATION

## INTRODUCTION

The collateral source rule<sup>1</sup> has long been a mainstay of American tort law. Recently, however, the traditional tort system has undergone tremendous scrutiny. Specifically, the collateral source rule has been criticized by commentators and scholars for conflicting with modern purposes of tort liability and the tort system in general.<sup>2</sup> This criticism prompted many state legislatures to change the rule. In Ohio, for example, the Supreme Court recently struck down the Legislature's attempt to do away with the rule.<sup>3</sup> Based on the criticism the rule has received and the fervor with which tort plaintiffs and their attorneys cling to the traditional rule, it is clear that the rule has important implications for all parties participating in the tort system and for those attempting to redesign it.

This Note concludes that the collateral source rule should be retained. The history and traditional justifications of the collateral source rule are reviewed in Part I. More recent criticism of the traditional rule from scholars and commentators who disagree about the relative importance of these justifications, as well as the resulting legislative and judicial activity,<sup>4</sup> are discussed in Part II. Parts III-V discuss three separate justifications of the tort system that

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1. Generally, the collateral source rule allows an insured tort plaintiff to retain both insurance benefits from an insurer and full damages from the defendant. *See infra* notes 5-8 and accompanying text.

2. *See infra* notes 23-35 and accompanying text.

3. *See infra* notes 36-53 and accompanying text.

4. Ohio is used as an example of this activity. The experience in Ohio is fairly representative of the legislative reforms and litigation regarding the statutory changes that have been occurring throughout the United States and should give the reader a flavor for the controversy.

support retaining the rule. These justifications include proper allocation of tort-caused losses, deterrence of risky behavior, and compensation for injuries. This Note argues that taken together these analyses will support retaining the rule.

While allowing a plaintiff to retain both insurance benefits and tort damages may produce inefficiencies of double payment, this Note proposes, in conjunction with retaining the traditional collateral source rule, that the practice of subrogation or reimbursement of the insurer out of the tort damages should be used more often and more efficiently as a method of decreasing any duplicitous recovery by the injured plaintiff. After discussing broad proposals for increasing the use and efficiency of subrogation/reimbursement practices in Part VI, this Note concludes that the collateral source rule can still be an important part of the tort recovery system.

### I. BACKGROUND

The collateral source rule provides that "if an injured person receives compensation for his injuries from a source wholly independent [collateral] of the tort-feasor, the payment should not be deducted from the damages which he would otherwise collect from the tort-feasor."<sup>5</sup> In other words, an injured plaintiff in a tort action can recover twice, from his own insurance policy and from the defendant. The rule has both damages and evidentiary aspects. First, as noted above, the damages aspect is that benefits received by the plaintiff from other sources are not credited or set-off against the tortfeasor's liability.<sup>6</sup> Second, since "the receipt of collateral benefits is deemed irrelevant and immaterial on the issue of damages, it follows, as a necessary concomitant . . . that the receipt of such benefits is not to be admitted in evidence, or otherwise disclosed to the jury."<sup>7</sup> The jury is not permitted to hear this information in order to foreclose any improper inferences as to the amount of damages or the liability of the defendant.<sup>8</sup>

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5. BLACK'S LAW DICTIONARY 262 (6th ed. 1990).

6. See RESTATEMENT (SECOND) OF TORTS § 920A(2) (1977).

7. *Pryor v. Webber*, 263 N.E.2d 235, 239 (Ohio 1970). *But see* Joel K. Jacobsen, *The Collateral Source Rule and the Role of the Jury*, 70 OR. L. REV. 523, 525-26 (1991) (arguing that rote categorization of the rule as both a damages and evidence rule is unnecessary and confusing and that evidence of collateral benefits should be admissible when offered for purposes other than reducing damages).

8. See *Pryor*, 263 N.E.2d at 239.

The history of the collateral source rule in the United States is often traced to *The Propeller Monticello v. Mollison*.<sup>9</sup> *Monticello* was a Supreme Court admiralty case in which the defendant-steamship raised as a defense that the plaintiff-schooner, rammed and sunk by the steamship, had been insured and fully compensated.<sup>10</sup> The Court, effectively espousing the collateral source rule, affirmed the circuit court's holding denying this defense and stated that the defendant cannot avail himself of the benefit of the plaintiff's insurance "wager."<sup>11</sup> The Court explained that it was merely stating a rule that was well established at common law.<sup>12</sup>

The rule's vitality continued in the United States and has been established in almost every state.<sup>13</sup> In Ohio, the leading case is *Pryor v. Webber*.<sup>14</sup> In *Pryor*, the defendant attempted to introduce into evidence wages received by the plaintiff from her employer while she was injured.<sup>15</sup> The court reaffirmed Ohio's adherence to the collateral source rule and held that the evidence was inadmissible.<sup>16</sup>

Although the collateral source rule may have originated as an evidentiary or damages rule, other justifications have been offered by modern courts and scholars to explain its continued use. First, the wrong-doing tortfeasor should not be allowed to benefit, or be relieved of liability, due to the plaintiff's foresight in obtaining insurance.<sup>17</sup> If the defendant is found liable to the plaintiff for damages, then offsetting the insurance benefits against the damages is a boon to the defendant.

Second, if a tort recovery made after insurance benefits are received is considered a windfall to the plaintiff, it is preferable to

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9. 58 U.S. (17 How.) 152 (1854).

10. *See id.* at 154.

11. *See id.* at 155.

12. *See id.*

13. *See* Linda J. Gobis, Note, *Lambert v. Wrench: Another Step Toward Abrogation of the Collateral Source Rule in Wisconsin*, 1988 WIS. L. REV. 857, 860.

14. 263 N.E.2d 235 (Ohio 1970).

15. *See id.* at 238 (explaining that the defendant's relevance theory was that the plaintiff had lied about her true damages since she was "compensated" for her injuries by her disability wages).

16. *See id.* at 243.

17. *See* Gobis, *supra* note 13, at 862. *But see* Lawrence P. Wilkins, *A Multi-Perspective Critique of Indiana's Legislative Abrogation of the Collateral Source Rule*, 20 IND. L. REV. 399, 401-02 (1987) (arguing that there is no logical reason that a third-party cannot benefit from the plaintiff's insurance contract and only a court's moral opposition to giving a benefit to a wrong-doer prevents such a result).

giving the defendant a windfall by relieving him of liability.<sup>18</sup> Since the tortfeasor is the more culpable party and was merely lucky to injure an insured victim, the windfall should not go to the tortfeasor.

Third, permitting recovery from both the plaintiff's insurer and the defendant is favored since money cannot truly compensate for physical injuries or pain incurred.<sup>19</sup> Since the injured party's damages are only a guess by the insurance company or jury, additional recovery protects against low estimates.

Fourth, the insurance company and the plaintiff previously contracted for the payment of these benefits. The insurer has a duty to pay the benefits and the plaintiff has a right to the benefits regardless of the plaintiff's ability to recover from a third-party tortfeasor.<sup>20</sup> Since the insurance company has already been paid premiums to bear an actuarial risk, the benefit payments it must make are simply a cost of doing business that has already been contracted and paid for by the plaintiff.

Lastly, unless the defendant is made to pay for the damages caused, the deterrent purposes of tort liability<sup>21</sup> will be undermined.<sup>22</sup>

## II. RECENT HISTORY

Despite its deeply ingrained roots in American common law, the collateral source rule has been criticized by commentators and

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18. See Christopher J. Eaton, Comment, *The Kansas Legislature's Attempt to Abrogate the Collateral Source Rule: Three Strikes and They're Out?*, 42 U. KAN. L. REV. 913, 920 (1994).

19. See *id.*; *Hudson v. Lazarus*, 217 F.2d 344, 346 (D.C. Cir. 1954) (stating that compensatory damages do not really compensate since a person would not be willing to sell a body part). But see RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* §§ 6.11-12 (3d ed. 1986) (discussing the need to estimate damages and stating that all damages are measurable in an economic sense).

20. See Jacobsen, *supra* note 7, at 531-32 (expressing this argument as the benefit-of-the-bargain rationale). The agreement between the insurer and the insured may also have provided the insurer with subrogation rights to the plaintiff's claim against the defendant, in which case the insurer would have priority to the damages received from the defendant. Subrogation is discussed more fully at *infra* notes 139-195 and accompanying text and is proposed as part of the solution to the collateral source rule debate.

21. See RESTATEMENT (SECOND) OF TORTS § 901(c) (1977) (stating that one of the purposes of tort damages is to "punish wrongdoers and deter wrongful conduct").

22. See Eaton, *supra* note 18, at 920 (stating that to allow evidence of collateral benefits to reduce a tortfeasor's liability would lessen the deterrent effect that civil liability offers).

scholars. The rule is said to have evolved from opposing theories of tort law,<sup>23</sup> and has been called a high-ranking oddity of accident law.<sup>24</sup> One of the most frequent objections to the collateral source rule is that the plaintiff should not receive a fortuitous double-recovery simply for being the victim of tortious conduct and receiving insurance benefits at the same time.<sup>25</sup> Since an important purpose of tort compensation is to indemnify only the harm suffered by the victim,<sup>26</sup> this double-recovery would overcompensate the plaintiff and put him in a better position than before the tort occurred.<sup>27</sup> A serious implication of a double-recovery for the plaintiff is that it could produce a moral hazard.<sup>28</sup> If the plaintiff were to receive a double-recovery, the plaintiff would have incentive to become a tort victim; certainly this is an incentive society would not want to promote.

Another argument against the collateral source rule is that it is too rooted in a punitive or deterrence theory of tort liability.<sup>29</sup> The importance and efficacy of the deterrent impact of tort liability has been hotly debated for many years.<sup>30</sup> Relying on the argument that tort liability does not affect human behavior and deter unsafe conduct, opponents of the collateral source rule consider deterrence a weak justification.<sup>31</sup> In addition, mitigating factors such as liability insurance and the inability of tort liability to deter inadvertent conduct, may dull the deterrent impact of tort liability.<sup>32</sup>

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23. See Julie A. Schafer, Note, *The Constitutionality of Offsetting Collateral Benefits Under Ohio Revised Code Section 2317.45*, 53 OHIO ST. L.J. 587, 589 (1992) (arguing that the compensation and deterrence goals of tort law are irreconcilable).

24. See John G. Fleming, *The Collateral Source Rule and Loss Allocation in Tort Law*, 54 CAL. L. REV. 1478, 1478 (1966).

25. See Schafer, *supra* note 23, at 590.

26. See RESTATEMENT (SECOND) OF TORTS § 901(a) (1977) (stating that tort damages exist "to give compensation, indemnity, or restitution for harms").

27. See Schafer, *supra* note 23, at 590.

28. See ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES AND COMMERCIAL PRACTICES* § 3.1(c) (Practitioner's ed. 1988) (describing that if an insured could realize a net gain from insurance, it would encourage using insurance as a way of wagering).

29. See Eaton, *supra* note 18, at 922 (stating that tort law should focus on the injury and not on deterring unsafe behavior).

30. See Gary T. Schwartz, *Reality in the Economic Analysis of Tort Law: Does Tort Law Really Deter?*, 42 UCLA L. REV. 377, 381-387 (1994) (providing a comprehensive list of recent authors who doubt the deterrent effect of tort liability and the factors they suggest mitigate deterrence).

31. See Eaton, *supra* note 18, at 922; Gobis, *supra* note 13, at 885 (stating that the deterrent effect of the collateral source rule is "speculative" and "unrealistic").

32. See Schwartz, *supra* note 30, at 381-87; see also *infra* notes 84-92 and accompa-

These theoretical arguments pale in comparison to the arguments of the insurance industry. Industry analysts argued that the collateral source rule's double recovery for plaintiffs was a contributing factor to the liability insurance availability and affordability crises in this country in the early to mid-1980s.<sup>33</sup> The collateral source rule is an easy target for insurance company lobbyists due to the windfall nature of a double recovery and increasing public indignation of highly-publicized jury verdicts.<sup>34</sup> Based on the perceived need for a solution to this crisis, many state legislatures passed comprehensive tort reform packages in the latter half of the 1980s. Statutory elimination of the collateral source rule in some form was a common factor among these different packages.<sup>35</sup>

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nying text.

33. See REPORT OF THE TORT POLICY WORKING GROUP ON THE CAUSES, EXTENT AND POLICY IMPLICATIONS OF THE CURRENT CRISIS IN INSURANCE AVAILABILITY AND AFFORDABILITY 1, 4, 70, 80 (Feb. 1986) (recommending that the collateral source rule be abolished). But see Leonard W. Schroeter & William J. Rutzick, "Tort Reform"—*Being an Insurance Company Means Never Having to Say You're Sorry*, 22 GONZ. L. REV. 31 (1987) (providing an impassioned rebuttal of the actual existence of an insurance crisis in this country and accusing the insurance industry of perpetrating a fraud on the public in order to persuade legislative officials to pass beneficial tort reform legislation and justify large premium increases). Determining whether a crisis existed in the insurance industry during the 1980s is beyond the scope of this Note and may be impossible in any case. There are persuasive arguments and statistics on each side. Regardless of the outcome of this debate, basing statutory reforms on controversial and inconsistent data is questionable at best, and partisan politicizing at worst. A more rational and conservative approach, with deference to common law traditions and in conjunction with more efficient loss cost recovery as this Note suggests, is a better policy.

34. It is important to note that the traditional collateral source rule only provides a double recovery for the economic damages portion of the award. First-party medical insurance does not cover non-economic damages such as pain and suffering and punitive damages. Since the plaintiff would retain these types of damages from a jury verdict if there was no collateral source rule, the double recovery argument should be separated from the recoil against high punitive or intangible damage awards. It is true, however, that the collateral source rule could provide multiple recoveries of economic damages if the victim was insured by more than one insurer for the same injury. This is a coordination of benefits problem with the insurance policies which would occur even if the victim did not enter the tort system. This problem would occur, for example, if the victim had both medical insurance and a personal injury rider on his automobile insurance policy. See KEETON & WIDISS, *supra* note 28, at § 3.11(d) (indicating that many health insurance policies do not limit coverage based on excess insurance carried by the insured).

35. See CAL. CIV. CODE § 3333.1 (West Supp. 1996); FLA. STAT. ANN. § 768.76 (West Supp. 1996); see also 4 FOWLER V. HARPER ET AL., THE LAW OF TORTS 219-22 (2d ed., 1996 Cum. Supp. No. 1, 1986) (providing a more complete summary of states with statutorily modified collateral source rules); Schafer, *supra* note 23, at 608 n.99.

The Ohio Legislature passed a comprehensive tort reform bill in 1987.<sup>36</sup> The purpose of the bill was "to make changes in civil justice and insurance law, thereby reducing the causes of the current insurance crisis and preventing future crises."<sup>37</sup> This Bill changed Ohio's common law collateral source rule; it required courts to subtract collateral benefits received by the plaintiff from compensatory damages awarded by the jury.<sup>38</sup> The new law required the plaintiffs to disclose collateral benefits to the court at the conclusion of the trial. Such benefits were then subtracted from the compensatory damage verdict.<sup>39</sup>

In addition to helping solve the liability insurance crisis, the change in the common law collateral source rule was "designed to prevent double recovery" by a plaintiff.<sup>40</sup> Not surprisingly, with potentially large verdicts and attorney fees at stake, this new rule generated much litigation in Ohio courts.<sup>41</sup> Although the state courts of appeal consistently held R.C. Section 2317.45 to be constitutional, the Ohio Supreme Court agreed to grant review to such a case in 1994.<sup>42</sup>

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36. Am. Sub. H.B. 1, 117 G.A., Reg. Sess. (Ohio 1987-88).

37. *Id.*

38. See OHIO REV. CODE ANN. § 2317.45 (Banks-Baldwin 1994). The pertinent text of § 2317.45(B)(2)(c) is as follows:

(c) Prior to entering judgment for the plaintiff, [the court shall] do both of the following:

(i) Subtract from the compensatory damages that the plaintiff otherwise would be awarded the amount of any disclosed collateral benefits. . . .

§ 2317.45(B)(2)(c).

39. See § 2317.45(B)(2)(c). Placing the hearing at the conclusion of the trial makes a concession to the evidentiary concerns created if the defendant was allowed to present evidence of the plaintiff's collateral benefits to the jury. See § 2317.45(B)(3) (stating that evidence of collateral benefits is not admissible before the trier of fact). Also, the statute recognized that the plaintiff may have paid for the collateral benefits and allowed for a reduction in the offsets for premiums paid for the insurance coverage. See § 2317.45(B)(2)(c)(ii). The setoff statute does not apply to collateral benefits which are subject to "rights of recoupment" or subrogation claims by an insurer. See § 2317.45(B)(2)(a)(ii) & (B)(2)(b). This would allow an insurer to recover the benefits it had paid to the insured. See also *infra* notes 139-157 and accompanying text (discussing subrogation).

40. See STANTON G. DARLING II, OHIO CIVIL JUSTICE REFORM ACT 131 (1987) (providing interpretations and legislative history commentary on the entire tort reform act). Darling served as special advisor on tort and civil justice matters to the Office of the Speaker of the House in 1987 and drafted much of House Bill 1.

41. See Schafer, *supra* note 23, at 597-607 (describing Ohio cases dealing with these new statutes).

42. See *Sorrell v. Thevenir*, 633 N.E.2d 504 (Ohio 1994).



In *Sorrell*, the plaintiff suffered back injuries when the defendant jokingly grabbed her from behind while she was bent over sweeping dirt into a dust pan.<sup>43</sup> The plaintiff had received \$14,335 in worker's compensation benefits as a result of her injury.<sup>44</sup> At trial the plaintiff was awarded \$1,700 for lost wages, \$3,428 for medical expenses, and \$5,000 for pain and suffering.<sup>45</sup> Following the trial, the court held a hearing to determine the amount of collateral benefits to be used to offset the jury award.<sup>46</sup> Theoretically, the jury verdict would have been totally offset by the worker's compensation benefits which were higher than the verdict; Ms. Sorrell would have received nothing.<sup>47</sup> At the hearing, the plaintiff argued that the collateral source setoff was unconstitutional.<sup>48</sup> The trial court agreed and declared the statute unconstitutional.<sup>49</sup>

The Court of Appeals reversed.<sup>50</sup> The Supreme Court, in turn, reversed the Court of Appeals and declared the statute unconstitutional on a number of grounds.<sup>51</sup> It is interesting that the

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43. See *Sorrell v. Thevenir*, No. 91 CA 4, 1992 Ohio App. LEXIS 5098, at \*2 (Gallia Cty. Sept. 30, 1992).

44. See *id.*

45. See *id.*

46. See *id.* at \*2-\*3.

47. In fact, the defendant, only partially in jest, suggested that Ms. Sorrell owed him and his attorneys the difference between the judgment and her worker's compensation benefits. See Brief of Plaintiffs-Appellants at 1-2, *Sorrell v. Thevenir*, 633 N.E.2d 504 (Ohio 1994) (No. 91-CA-04).

48. See *Sorrell v. Thevenir*, No. 91 CA 4, 1992 Ohio App. LEXIS 5098, at \*3 (Gallia Cty. Sept. 30, 1992).

49. See *id.*

50. See *id.* at \*10. The Court of Appeals emphasized that they were not passing on the legislative wisdom of the statute, but rather relying on Supreme Court precedent approving a similar collateral source setoff statute for medical malpractice claims. See *id.* (citing *Morris v. Savoy*, 576 N.E.2d 765 (Ohio 1991) (upholding R.C. § 2305.27 under state constitutional equal protection and due process attack)). The court also welcomed Supreme Court review of the issue in this case. See *id.*

51. See *Sorrell v. Thevenir*, 633 N.E.2d 504, 510-513 (Ohio 1994) (R.C. § 2317.45 restricts the right to a jury trial, does not provide due process of law to tort victims, is constitutionally infirm on equal protection grounds, and hinders the plaintiff's rights to a remedy and to an open court). Other state courts have also declared collateral source setoff statutes to be unconstitutional on similar grounds. See, e.g., *Denton v. Con-Way S. Express, Inc.*, 402 S.E.2d 269 (Ga. 1991) (striking down GA. CODE ANN. § 51-12-1 (1987), an evidentiary abolition of the collateral source rule, as violating the Georgia Constitution's impartial and complete protection of person and property). But see *Fein v. Permanente Medical Group*, 695 P.2d 665 (Cal.) (upholding CAL. CIV. CODE § 3333.1 (Michie Supp. 1995) as not violating medical malpractice plaintiff's due process or equal protection rights), *appeal dismissed*, 474 U.S. 982 (1985).

Court vowed to ignore policy implications of the statute and to refrain from debating the wisdom of the legislature's action.<sup>52</sup> In fact, the Court's opinion is scattered with references to policy justifications for and against the collateral source rule.<sup>53</sup> The Court simply ignored its own limitation, and proceeded to base its decision on policy grounds. Whether or not the *Sorrell* court improperly invaded a legislative policy-making domain is an important question, however, its answer is beyond the scope of this Note.

This type of judicial opposition to changes in the traditional rule shows that the debate is still open at the state level. If state legislatures pursue this type of tort reform measure, they must decide whether or not to redraft a change to the common law rule that will satisfy the court's constitutional requirements. Although legislative activity on this count has been minimal,<sup>54</sup> it is quite possible that the liability insurance industry, given its cyclical nature,<sup>55</sup> will find itself in another investment return/premium competition squeeze. When that happens, industry lobbyists will

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52. See *Sorrell*, 633 N.E.2d at 508 (stating that the Court's duty is merely to determine the constitutionality of the statute as an exercise of legislative power).

53. The plaintiff may not be fully compensated if required to offset the verdict with collateral benefits. See *id.* at 510. The tortfeasor is granted a windfall if he does not have to pay for the damages he caused. See *id.* The collateral source setoff statute may or may not ease the liability insurance crisis. See *id.* at 511. The statute prevents the plaintiff from receiving a double recovery. See *id.* The plaintiff has a right to both the insurance proceeds and the verdict damages since the insurance benefits were previously bargained for. See *id.* at 511-12. The dissenting judge argued that this holding ignores the underlying purpose of the tort system to only compensate the victim for the amount of damages or the amount the jury deems a just and appropriate reward. See *id.* at 513 (Moyer, C.J., dissenting).

54. In Ohio, the State House of Representatives revised the setoff statute as part of the 1995 Tort Reform Package. H.B. 350, (A) § 2317.45 (Ohio 1995). The much abbreviated provision simply allows both plaintiff and defendant to present evidence to the jury of premiums paid to and benefits received from a collateral source. See § 2317.45. The House intended to do away with the common law rule and address the *Sorrell* court's constitutional objections to the previous setoff statute. See comments to H.B. 350 at (E). The new version did not survive the committee hearings and the House eventually passed a bill that only allows the defendant to introduce evidence of insurance benefits for which the plaintiff did not pay a premium. See AM. SUB. H.B. 350, (A) § 2317.45; Catherine Candisky, *House Passes Measure: Tort Reform*, THE COLUMBUS DISPATCH, Feb. 8, 1996, at 1C. The bill was finally sent to Governor George Voinovich, who indicated he would sign it, on September 26, 1996. See Thomas Suddes, *House OK's Bill to Cap Personal-Injury Awards*, THE PLAIN DEALER (Cleveland), Sept. 27, 1996, at 5B.

55. See Schroeter & Rutzick, *supra* note 33 (describing previous instances of insurance crises which prompted insurance companies' efforts at tort reform).

surely knock down state house doors across the country clamoring for relief just as they did in the 1980s. It is likely that changes to the traditional collateral source rule will be part of the relief measures offered if the rule has not yet been modified.

If a state legislature considers a collateral source setoff statute, more careful thought should be given to the justifications for and against the traditional rule than has been given in the past. Clearly, the current collateral source rule debate is too simple, short-sighted, and partisan. The opposing sides, divided right down plaintiff-defendant party lines,<sup>56</sup> either favor the traditional rule or condemn it with wholly self-interested views.<sup>57</sup> The plaintiffs want what they think is rightfully theirs, and the defendants want to avoid paying damages to a previously compensated plaintiff. The debate has lost sight of the reasons why the traditional rule developed—to foster and enhance the purpose of the tort system as it existed at the time of the development of the common law rule.<sup>58</sup> In order to reach a resolution, it must be determined whether the collateral source rule performs or does not perform a similar function under our current tort system.<sup>59</sup>

This Note extends the debate past the narrow party-minded arguments toward a more positive analysis of whether the rule is supported by modern theories of tort law and whether the rule has a place in the tort system. Three major justifications of the tort system found in the recent literature define the analysis: (1) risk allocation/loss-spreading; (2) deterrence; and (3) compensation.

A conclusion that the collateral rule does not magically fit all of the justifications given for tort liability does not require that it be dismissed as out-dated. It must be determined whether the costs

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56. The party becomes more complicated when insurers, attorneys, lobbyists, legislators, and activist courts are added.

57. See *supra* notes 17-35 and accompanying text (discussing the standard arguments for and against the collateral source rule).

58. See Kenneth S. Abraham, *What is a Tort Claim? An Interpretation of Contemporary Tort Reform*, 51 MD. L. REV. 172, 192-93 (1992) (hypothesizing that the rule originated when insurance was an uncommon phenomenon in order to ensure those prudent enough to purchase insurance the receipt of their benefits, but also stating that increased insurance coverage may have changed the need for the rule).

59. The question may be posed this way: if there were no collateral source rule, given the current state of the tort system and the goals which it achieves or we wish it could achieve, would we create a rule similar to the common law rule to enhance the purposes of the tort system?

associated with the traditional collateral source rule are outweighed by the benefits.

### III. RISK ALLOCATION & SCALE OF ACTIVITY

Many justifications for the tort system focus on the actions of the tortfeasor and the deterrent effect of tort liability.<sup>60</sup> The most common concept of deterrence is whether the threat of liability prevents an individual or firm from engaging in risky behavior.<sup>61</sup> This section of the Note will discuss a less common concept termed "scale of activity" deterrence.<sup>62</sup> It is clear that a goal of tort liability is to optimize, not eliminate, risky behavior.<sup>63</sup> Some risky behavior is considered valuable by our society even if it results in damages. The difficulty lies in determining what level of risky behavior is socially optimal. The amount or level of risky behavior being measured is called the scale of an activity.

Many law and economics scholars believe that an optimal scale of activity can be more closely attained by the use of tort liability. Guido Calabresi terms the determination of the optimal level of risky behavior the "allocation of resources" justification of tort liability.<sup>64</sup> His thought was that if society wants certain goods, then obstacles to production should be overcome, and the goods should be produced.<sup>65</sup> To enable society to make the optimal choice between the desirable goods or activities and the risks associated with them, the full cost of producing the good or engaging in the activity must be included in the price society pays for that good or activity. These costs include the normal cost of inputs such as labor and materials, as well as the damages caused by

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60. See RESTATEMENT (SECOND) OF TORTS § 901A (1977) (listing "deterrence of tortfeasor" as one purpose of the tort system).

61. See *infra* Section IV, notes 77-116 and accompanying text.

62. Guido Calabresi calls these different aspects specific deterrence and general deterrence respectively. See GUIDO CALABRESI, *THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* 131-97 (1970) [hereinafter CALABRESI, *THE COSTS OF ACCIDENTS*].

63. See WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 13 (1987).

64. See Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 *YALE L.J.* 499, 502 (1961) [hereinafter Calabresi, *Thoughts on Risk Distribution*]; see also Stanley Ingber, *Rethinking Intangible Injuries: A Focus on Remedy*, 73 *CAL. L. REV.* 772, 793-819 (1985) (quoting extensively from Calabresi's works and applying the theory to his discussion on the tort system's mechanisms for dealing with intangible or non-pecuniary injuries).

65. See Calabresi, *Thoughts on Risk Distribution*, *supra* note 64, at 502.

producing the good or engaging in the activity. If the value to society of a particular good or activity is equal to or more than the cost of production, then production or activity will increase and society will pay for it. If the value to society is less than the cost of production, including damages, then production or activity will decrease. This function of price, reflecting full cost, is an important component of society's choice of whether to buy the good or engage in the activity.<sup>66</sup>

Clearly, the only way that the full cost can be reflected in the price is if the producer must pay for damages caused by the production of the good or activity. If the producer is monetarily liable, then the price charged to consumers will reflect this liability so that the producer can cover the costs of production. If the price of the good does not reflect damages caused, as would be the case if the producer is not monetarily liable for damages caused, then society will buy more of a good or engage in more of an activity.<sup>67</sup> Since society's demand for a good or activity has increased due to the lower than optimal price, the producer will respond by increasing the supply of the good or activity above the socially optimal level.

More recently, Steven Shavell has shown that if an injurer is not liable for the damages he causes, he will over-engage in an activity.<sup>68</sup> Since the injurer, in the absence of liability, does not have to pay for the damages caused or expend his own resources to try to prevent accidents from occurring, theoretically, he could engage in a dangerous activity without thinking about its consequences.<sup>69</sup>

The traditional collateral source rule correctly places the monetary liability for damages caused due to wrongful behavior on the injuring party.<sup>70</sup> According to Calabresi and Shavell, if the full

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66. *See id.*

67. This above- or below-optimal purchasing is an inefficiency introduced by the externalization of the cost of the damages from the producer to the consumers. *See* CALABRESI, *THE COST OF ACCIDENTS*, *supra* note 62, at 70.

68. *See* STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 21-32 (1987). Actually, in the absence of liability, the injurer will engage in an activity up to the point where additional activity is actually a burden on the injurer. *See id.* at 22 n.29. Shavell's level of activity analysis is similar to the situation where a firm engages in the production of goods and is sensitive to consumer demand based on price levels. *See id.* at 49.

69. In the case of a firm producing a level of goods in response to consumer demand, the firm could still produce goods without giving thought to the injuries or damages caused up to the point where the supply of the good is still met by consumer demand.

70. A no-fault automobile insurance plan, see generally ROBERT E. KEETON & JEFFREY

cost of the damages caused by the activity or production of goods is not reflected in the price or borne by the injuring party, then too much activity will be engaged in or too many goods will be produced. The collateral source rule places the cost of damages on the injuring party so that it is reflected in the cost of the good. If the collateral source rule did not apply in tort liability cases, then the injuring party would not be fully liable for the damages.<sup>71</sup> There would then be no reason for the monetary liability to be reflected in the cost of the good produced.

The scale of activity or allocation of resources argument for imposing tort liability on the injurer is not without its critics.<sup>72</sup> Stephen Sugarman argues that these theories are not strong enough to justify retaining tort liability. His most compelling objection is that simply internalizing the costs of torts may not lead to a more efficient allocation of resources.<sup>73</sup> This uncertainty stems from the economic theory of "second-best."<sup>74</sup> As applied to the allocation of tort liability, this theory suggests that simply making one allocation of cost, based on fault or damage causation, has an unpredictable effect on the optimal level of production due to the many other economic factors that are simultaneously affecting the level

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O'CONNELL, BASIC PROTECTION FOR THE TRAFFIC VICTIM (1965) (describing the objectives of the automobile claims system), allocates the cost of the activity without using fault as a criterion for the allocation of damages. See CALABRESI, THE COST OF ACCIDENTS, *supra* note 62, at 7-10. However, no-fault insurance is designed to provide first-party compensation in accidents where both parties are usually involved in the same activity. In that special case, the allocation of damages is *de facto* placed correctly on the injury causing activity, driving. In a more general tort case, however, if the victim was not also participating in the same activity as the injurer, or was simply a consumer of goods, then allocating damage costs to a victim under a no-fault type compensation plan would not correctly allocate the costs to the activity that caused the damages.

71. In the simplest case, with the plaintiff incurring only medical costs and lost wages, a collateral benefit setoff rule would result in a 100% setoff of tortfeasor liability because of benefits received by the plaintiff. The effect of the rule, then, is no liability.

72. See, e.g., Stephen D. Sugarman, *Doing Away With Tort Law*, 73 CAL. L. REV. 555, 613-16 (1985) (arguing additionally that the allocation of resources argument may be confused with other justifications for tort liability; that it may not fully consider the proper allocation of damages from accidents which are truly nobody's fault; that its purpose may be defeated by the self-externalizing function of insurance premiums; and that the inherent inefficiency of tort damages in correctly allocating costs may destroy any allocative benefits from assigning tort liability).

73. See *id.* at 615.

74. See Richard S. Markovits, *Monopoly and the Allocative Inefficiency of First-Best-Allocatively-Efficient Tort Law in Our Worse-Than-Second-Best World: Some Whys and Some Therefores*, 46 CASE W. RES. L. REV. 313, 316-17 (1996) (defining the "second best" theory).

of production. Changing one factor in the mix in an attempt to improve the situation may actually worsen it, since the interplay of other factors with the changed factor is not known.<sup>75</sup>

Although the argument is a potentially serious consideration for the debate over whether to retain tort law liability at all, it does not damage the allocative argument to retain the collateral source rule in our current tort liability system. That is so since the collateral source rule debate is practicably limited to the world where no drastic or overwhelming changes will be made in the fault-based system through which tort victims are compensated. Since that system is unlikely to change,<sup>76</sup> the allocative argument for retaining the rule operates within the framework of the current fault-based system. Sugarman's "second-best" theory on tort liability does not extend to this framework; it is limited to the broader question of whether tort liability should be retained.

Within a fault-based framework, the "second-best" theory does not indicate that the collateral source rule distorts the level of production. Keeping the cost of accidents on the injurer via the collateral source rule will not result in a more drastic distortion in the allocation of resources than those distortions that already occur in the tort liability system. In fact, in choosing between placing full liability on the injurer under the traditional rule or in reducing liability under a setoff statute, the theory of "second-best" would imply that it would be difficult to determine which allocation is more efficient. It is possible that reducing tort liability to the extent of collateral benefits may distort the allocation to the same extent as imposing full liability.

For the scale of activity rationale to be effective in helping society choose the optimal level of goods to produce or activity to engage in, the traditional collateral source rule should be retained. Without the collateral source rule, injuring parties and producers of goods will engage in too much dangerous activity or produce too many dangerous goods. In turn, this would increase the injuries and damages beyond the optimal level that society, if given the

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75. *See id.*

76. If drastic changes were made, such as a conversion to an all-encompassing government social insurance for accidents or to an entirely no-fault based system for all tort accidents, the collateral source rule would almost by definition be unnecessary or unworkable.

choice, would select through pricing and supply/demand mechanisms.

#### IV. DETERRENCE OF UNSAFE BEHAVIOR

Many commentators contend that because the deterrence purpose of tort liability has faded in importance, it is also no longer a supportable justification for the continued use of the collateral source rule.<sup>77</sup> The deterrence justification for tort liability has been revived recently, however, through the law and economic positivist analysis.<sup>78</sup> For this reason, it is difficult for these commentators and litigants to continue to maintain that deterrence has no scholarly support as a purpose of the tort system or the collateral source rule.

The difficulty in determining whether the deterrence theory is a valid justification is that there are persuasive theoretical arguments both for and against the efficacy of this theory. Additionally, the actual deterrent impact of tort liability is difficult to measure in any satisfactory empirical fashion. Early attempts at empiricism were often apocryphal investigations into the impact of a few celebrated cases. The later attempts at investigating the impact of liability have been more structured and scientific, but even these studies have been criticized.<sup>79</sup> Even so, if it is accepted that deterrence still plays a role in the tort system, then abolishing the collateral source rule will certainly decrease the deterrent impact of tort liability and lead to a higher than optimal level of risky behavior. As explained below, the setoff of liability by collateral benefits will fully or partially reduce the deterrent effect of tort liability. Deterrence of risky behavior may not by itself justify preserving the traditional rule. As this Note argues, however, in combination with the allocation of resources and compensation arguments, plus more efficient subrogation, an increase in the deterrence of risky

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77. See Eaton, *supra* note 18, at 922 (stating that none of the mainstream theories of human behavior support the likelihood that tort sanctions appropriately deter unsafe behavior); Gobis, *supra* note 13, at 885 (explaining that increased defendant liability is a speculative deterrent).

78. See *infra* notes 80-116 and accompanying text (discussing both theoretical and empirical arguments in support of the law and economics inspired resurgence of the deterrence purpose of tort liability).

79. See *infra* notes 80-92 and accompanying text (discussing the theoretical arguments); notes 93-116 and accompanying text (discussing the empirical findings).



behavior will swing the balance towards retaining the traditional rule.

### A. Deterrence—Theoretical Arguments

Posner states that the major economic function of tort law and the imposition of liability on tortfeasors is not compensation, but rather the deterrence of inefficient accidents.<sup>80</sup> Allowing the defendant in an accident liability case to use the victim's insurance as an offset to the defendant's liability would decrease the deterrent effect of liability on the defendant.<sup>81</sup> For instance, if a defendant were liable for \$10,000 in damages, but the liability was offset by the collateral benefits received by the plaintiff, then the defendant's incentive to spend up to \$10,000, discounted for the probability of the accident occurring, would be reduced by this discounted value.<sup>82</sup> The view that tort law deters unsafe behavior to the full economic extent of the tort liability can be called the "strong" form of the deterrence argument.<sup>83</sup>

The critics of the strong form offer realistic objections to the deterrent impact of liability. Such objections include: the deterrent effect of other behavior controls besides tort liability, the diluting effect of liability insurance on deterrence, the inability of liability to deter unintentional behavior, and the psychological limitation of individuals to properly perceive and respond to risks.<sup>84</sup>

The first objection, the existence of other behavior controls, may raise the question of whether tort liability can be partially or wholly supplanted as a deterrent. Parties who engage in unsafe behavior may be deterred by other incentives such as moral obliga-

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80. See POSNER, *supra* note 19, § 6.14; RESTATEMENT (SECOND) OF TORTS § 901 (1979) (stating that deterrence of wrongful conduct is accorded at least equal importance to compensation of harms caused as a purpose of tort law).

81. See POSNER, *supra* note 19, § 6.13.

82. See *id.*

83. See Schwartz, *supra* note 30, at 378 (coining the weak/moderate/strong nomenclature: the weak view is that held by collateral source rule opponents and tort law critics; the moderate view is that the deterrent effect, while still an important aspect of tort liability, is somewhat mitigated by other factors). Shavell also supports the deterrent impact of liability in the strong form. His determination of the effects of different liability schemes rests on a measurement of total social welfare or utility that includes the full measure or costs of liability on the decision whether to engage in risky behavior. SHAVELL, *supra* note 68, at 5-46 (equating total social welfare to utility from engaging in behavior less costs of taking care not to cause accidents less costs of accidents (tort liability)).

84. See Schwartz, *supra* note 30, at 382-83.

tions not to injure or by self-serving interests in personal safety.<sup>85</sup> An example of the latter would be personal safety concerns that prevent driving at excessive speeds when the risk to self is possibly greater than the risk to others. These other incentives, in and of themselves, probably cannot prevent people from engaging in risky behavior. They can, however, supplement the efficacy of tort liability.<sup>86</sup>

The remaining objections to the deterrent effect of tort liability reflect more on its effectiveness, when it is imposed, at deterring unsafe conduct. Liability insurance may create a buffer between the defendant and his tort liability obligations by shifting Posner's full economic deterrent pressure from the tortfeasor to the liability insurer.<sup>87</sup> If a defendant simply relies on an insurer to fulfill the liability, then the defendant has not faced any of the monetary penalties imposed by the jury that supposedly create a deterrent effect. The actual functioning of liability insurance coverage, however, may offset this shifting effect through the operation of deductibles, caps, and experience rating pricing mechanisms which shift the costs of tort liability back to the tortfeasor.<sup>88</sup> While liability insurance probably does reduce the full impact of tort liability for defendants, thereby eroding Posner's "strong" deterrent theory, the threat of increasing rates and incurring fixed and unavoidable costs certainly has an important impact on activities.

Since negligent torts are by definition committed unintentionally, it is argued that mental awareness of tort liability cannot deter someone from unintentionally causing an accident.<sup>89</sup> Inadvertent behavior, however, can be somewhat modified by certain precautionary choices: fixing a broken stairway in the case of homeowner negligence, engaging in proactive informed consent in medical malpractice, or improving compliance with manufacturing safety

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85. See Sugarman, *supra* note 72, at 561-64 (concluding that there would be a gap between how people would act under only these constraints and what is socially desirable, but arguing that tort law fails to fill in the remaining deterrent incentive).

86. See Schwartz, *supra* note 30, at 384.

87. See Sugarman, *supra* note 72, at 573 (explaining that complete liability insurance protection shifts the direct economic insurance pressure of tort law from the tortfeasor to the insurance companies).

88. See Schwartz, *supra* note 30, at 385 (noting that insurance premiums rise for those who drive negligently). *But see* Sugarman, *supra* note 72, at 577-81 (arguing that despite the potential deterrence-inducing mechanisms available to insurers, their actual use and resulting impact on risky behavior is minimal).

89. See Schwartz, *supra* note 30, at 383, 385-86.

regulations in product defect cases.<sup>90</sup> These actions may not prevent accidents, but they will help prevent the portion of accidents that has an inherent element of preventability.

In addition, although some individuals may be aware of tort liability possibilities and may even affirmatively attempt to reduce risky behavior, they are unable to perceive the true risk level and cannot take the optimal level of precautionary measures.<sup>91</sup> Again, this mitigating factor is probably subject to offsetting considerations that will retain some of the deterrent impact of liability. In fact, the inability to assess risks properly may lead to an equal amount of overestimation or underestimation. However, if there is an awareness of the possibility of liability, there may be incentives to become educated about the risk levels. These incentives include the liability if risks are underestimated and the waste of resources if risks are overestimated.<sup>92</sup>

### B. Deterrence—Empirical Evidence

The question of whether tort liability deters socially unacceptable risky behavior is also an empirical one. Although this is a difficult measurement to make, attempts have been made to measure the decrease in accidents due to the imposition of liability.<sup>93</sup> More interesting, though, are studies that show increased accidents when liability is partially removed. Such is the case when no-fault automobile insurance regimes are instituted.<sup>94</sup> As mentioned earlier, empirical studies in this area are scarce, the results subject to heavy criticism, and the conclusions perhaps unpersuasive. This difficulty of proof, however, may not be fatal to the argument to preserve the collateral source rule.

An example of whether the imposition of liability changes behavior is the extent to which physicians have gone in order to reduce medical malpractice liability.<sup>95</sup> If the argument is that tort

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90. See *id.* at 386.

91. See *id.* at 386-87; see also Sugarman, *supra* note 72, at 569-73 (suggesting that many firms and individuals intentionally discount the risks of tort liability due to the inability of the tort system to assess the correct penalties; the fact that the potential gains from acting dangerously may outweigh the risks; and the small percentage impact even large tort liability may have on large corporations).

92. See Schwartz, *supra* note 30, at 387.

93. See *infra* notes 95-100 and accompanying text.

94. See *infra* notes 102-116 and accompanying text.

95. See generally Schwartz, *supra* note 30, at 397-404.

law does not deter tortious behavior due to the buffer of liability insurance, then it would follow that physicians would not undertake precautions to prevent malpractice. Schwartz provides many examples of how liability pressures have increased activity by the medical profession to reduce accidents. Some examples include increased under-age-forty glaucoma testing,<sup>96</sup> increased awareness of requirements to notify potential victims of dangerous patients,<sup>97</sup> increased efforts to improve patient informed consent procedures and standardize physician utilization of the process,<sup>98</sup> and increased awareness of surgical tools left in patients.<sup>99</sup> These are specific examples of heightened awareness due to publicized cases. Data also exists showing general attempts to improve the standard of care prompted by the increasing threat of liability and rising malpractice insurance premiums.<sup>100</sup> These procedural changes support the moderate deterrent effect argument. The specter of tort liability has helped increase the awareness and prevention of unsafe activity in medical procedures.

The second and more interesting type of empirical measurement that highlights the deterrent effect is whether there is an increase in risky behavior when tort liability is removed.<sup>101</sup> A common area of study on this issue is whether the imposition of no-fault automobile insurance causes an increase in accidents or fatalities. Either the strong or moderate form of deterrence would,

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96. See *Helling v. Carey*, 519 P.2d 981, 983 (Wash. 1974) (holding doctors liable for malpractice as a matter of law for not testing for glaucoma during a routine eye examination).

97. See *Tarasoff v. Regents of the Univ. of Cal.*, 551 P.2d 334, 342 (Cal. 1976) (requiring therapists to warn potential victims of patients' intent to harm them).

98. See *Canterbury v. Spence*, 464 F.2d 772, 781-92 (D.C. Cir. 1972) (discussing the evolution of the physician's duty to adequately inform his patient).

99. See Schwartz, *supra* note 30, at 399.

100. See *id.* at 402 (quoting significantly from PAUL C. WEILER, ET AL., A MEASURE OF MALPRACTICE 733 (1993) (indicating that liability, along with continuing medical education, peer review, and practice guidelines, is a factor in determining a doctor's standard of care)). There is no doubt that potential liability has greatly increased the practice of defensive medicine and added to skyrocketing health care costs. See *id.* at 402. This problem is, however, beyond the scope of this Note. The focus is rather on the ability of potential liability to encourage doctors to take these precautions at all in the light of the counter-argument that liability insurance dampens the deterrent effect of tort liability.

101. The elimination of the collateral source rule can be compared to the elimination of tort liability generally. Although the use of a setoff rule for collateral benefits would only reduce a defendant's liability to the extent of the benefits received by the plaintiff, the reduction of the deterrent effect would be similar. The magnitude of the reduction may be smaller, but it would be a reduction nonetheless.

in theory, indicate that moving from a fault-based system of accident liability to a no-fault system would result in reduced safety precautions by drivers and an increase in accidents. This would result from decreased incentives to drive carefully in the absence of liability.

This theory has generally held true. In a study that is often quoted, Elisabeth Landes showed that a \$1,500 liability threshold, below which claims for damages must enter the no-fault first party insurance compensation scheme, "implies an increase in fatal accidents of *more than 10 percent!*"<sup>102</sup> Landes performed a regression analysis on fatal accident rates for the period 1967-76 in states that enacted no-fault automobile insurance.<sup>103</sup> The study's intent was to isolate the effect on fatal accident rates due solely to the advent of no-fault insurance. If the ten percent figure is accurate, then aside from the serious policy implications on no-fault plans, the study supports a more general theory that in the absence of tort liability, more accidents occur due to the decreased deterrent effect of that liability.

Landes' study, however, has been criticized. Jeffrey O'Connell and Saul Levmore criticized Landes for her methodology.<sup>104</sup> They faulted her use of fatal accidents instead of injuries from accidents as a focus of study, her hypothetical driver who "superrationally" discounts his own injuries while being fooled by liability thresholds into driving less carefully, and her omission of many other important variables.<sup>105</sup>

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102. Elisabeth M. Landes, *Insurance, Liability, and Accidents: A Theoretical and Empirical Investigation of the Effects of No-Fault Accidents*, 25 J.L. & ECON. 49, 62 (1982) [hereinafter Landes, *The Effects of No-Fault*].

103. See *id.* at 59. Landes' calculations accounted for such variables as population, population density, variances in medical costs across states, each state's dollar threshold to bar tort recovery, age, sex, race, and the dramatic effect on the amount of driving due to gasoline price changes in the early 1970s. See *id.*

104. See Jeffrey O'Connell & Saul Levmore, *A Reply to Landes: A Faulty Study of No-Fault's Effect on Fault?*, 48 MO. L. REV. 649 (1983).

105. See *id.* at 650-52 (stating that since fatal accidents produce tort claims in all no-fault plans, the study should have concentrated on injury causing accidents where the boundaries of no-fault may encompass the claims; that such a hypothetical driver is technically inconsistent; and that omitted variables included weather, police enforcement, road quality, and medical care). Landes' stated reason for using fatalities is that the data is much more reliable. See Landes, *The Effects of No-Fault*, *supra* note 102, at 57-58 & 58 n.10. See also Sugarman, *supra* note 72, at 588-89 (partially rejecting O'Connell and Levmore's criticisms of Landes' study and offering as an alternative conclusion that instead of driving less carefully in no-fault states, drivers are simply driving more in the

Since Landes' study, other economists and statisticians have attempted to prove or disprove similar hypotheses with mixed results. A 1986 study by Paul Zador and Adrian Lund, sponsored by the Insurance Institute for Highway Safety, directly attacked Landes' methodology and came to the conclusion that "[m]ultiple regression analyses . . . provide[s] no support for the claim that the adoption of no-fault laws that restrict the liability for pain and suffering increased the frequency of fatal motor vehicle crashes."<sup>106</sup> However, a 1994 study by Frank Sloan found that barring twenty-five percent of tort liability claims through a no-fault program increases the fatality rate by eighteen percent.<sup>107</sup> Although Landes' results may have been reincarnated by Sloan's studies, the empirical side of the deterrence question is not satisfactorily answered by these studies.<sup>108</sup>

As Sloan indicated, the United States may not be the ideal case study for the no-fault question.<sup>109</sup> The 1978 implementation of a no-fault insurance plan in Quebec may provide better data for such a study since that plan provides for unlimited out-of-pocket losses and entirely does away with tort liability for personal injuries.<sup>110</sup> Statistical studies of the Quebec plan will thereby avoid the threshold problem in United States studies where tort liability is retained above a certain nominal dollar amount. The studies on the Quebec plan more conclusively show that the removal of the deterrent of tort liability increased the accident rate.

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absence of liability).

106. Paul Zador & Adrian Lund, *Re-Analyses of the Effects of No-Fault Auto Insurance on Fatal Crashes*, 53 J. RISK & INS. 226, 234 (1986) (including data collected through 1980 and criticizing the statistical methodology of Landes' study, not her choice of variables).

107. See Frank A. Sloan et al., *Tort Liability versus Other Approaches for Deterring Careless Driving*, 14 INT'L REV. L. ECON. 53, 66 (1994). Sloan concludes that overall, tort liability has a deterrent effect on careless driving. See *id.* at 68. However, he conceded that the United States "is not the ideal location to study the effects of no-fault laws." *Id.* at 69.

108. It is interesting to note that at the time her study was published, Landes was associated with the University of Chicago. See Sugarman, *supra* note 72, at 588 n.147. The law and economics school of thought, centered at the University of Chicago with Richard Posner and William Landes, clearly supports tort law as a deterrent. Additionally, the Zador-Lund study was supported by the Insurance Institute for Highway Safety, a group that would probably support no-fault insurance.

109. See *supra* note 107.

110. See Schwartz, *supra* note 30, at 395.

In his study of the Quebec plan, Marc Gaudry found that fatal accidents increased by seven percent, injury-only accidents increased by twenty-six percent, and property damage-only accidents by eleven percent.<sup>111</sup> Rose Anne Devlin was even more conclusive than Gaudry. She argued that regardless of an accident reporting effect, fatal accidents, which cannot be falsified or avoided, increased by almost ten percent in Quebec after the passage of the no-fault insurance regime in 1978.<sup>112</sup> Devlin has also published a report that attaches dollar values to the added accidents and compares them to the administrative savings from the additions of no-fault in Quebec.<sup>113</sup> She concluded that the increase in accidents under no-fault cost \$247 million as compared to administrative cost savings of \$94 million.<sup>114</sup>

These somewhat surprising statistics highlight one of the much-criticized features of no-fault insurance plans. No-fault insurance plans wholly ignored the deterrent impact of tort liability, attempted to decrease the overall costs of the accident compensation system by reducing transaction costs, and focused on increasing the availability and affordability of insurance.<sup>115</sup> The plans may have made insurance more available and affordable, but if the statistics cited above are believed, then the plans failed in even maintaining the level of accidents. If the increased accident costs were lower than the decreased transactions costs combined with the benefits of improved coverage, then the no-fault plans may have been justified. However, as the broad cost-benefit analysis of the fault to no-fault shift in Quebec shows, that was not the case.

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111. Marc Gaudry, *Measuring the Effects of the 1978 Quebec Automobile Insurance Act with the DRAG Model*, in CONTRIBUTIONS TO INSURANCE ECONOMICS 471, 491 (Georges Dionne ed. 1992) (indicating that other mitigating factors such as increased reporting practices under no-fault insurance and adverse risk selection by forcing young drivers to insure and therefore drive more may mitigate these increases).

112. Rose Anne Devlin, *Liability versus No-Fault Automobile Insurance Regimes: An Analysis of the Experience in Quebec*, in CONTRIBUTIONS TO INSURANCE ECONOMICS 499, 513-14 (Georges Dionne ed. 1992) (concluding that "[a] no-fault system . . . severs the link between compensation for an accident and amount of driving care").

113. Rose Anne Devlin, *Some Welfare Implications of No-Fault Automobile Insurance*, 10 INT'L REV. L. ECON. 193 (1990).

114. See *id.* at 198-99. These computations were based on Gaudry's results in his study on the increase in accidents, see *supra* note 111 and accompanying text, but could equally apply to Devlin's own results.

115. See POSNER, *supra* note 19, § 6.14.

The arguments in favor of retaining the collateral source rule surely benefit from these studies.<sup>116</sup> If a setoff statute were used, then the deterrent effect of tort liability would be reduced by the extent of the setoff. A setoff statute of that type would, in effect, create a no-fault regime for tortfeasors who are lucky enough to injure insured victims.

This may seem like a return to the "whose windfall is preferable" refrain, but it is not. The deterrent impact of tort liability will support placing liability on the tortfeasor in order to reduce the level of risky behavior and thereby reduce the cost of accidents. Although the mitigating factors, especially the dampening effect of liability insurance, may refute the strong theory of deterrence, there is no reason to believe that the moderate form of deterrence is harmed. A moderate form of deterrence may not alone be enough to support tort liability and the collateral source rule in the face of critics. It is, however, an additional factor that can help swing the balance in favor of retaining the collateral source rule.

#### V. COMPENSATION FOR INJURIES

Probably the most persuasive argument against the collateral source rule is that it overcompensates the plaintiff by creating a double recovery.<sup>117</sup> Admittedly, this argument is appealing. As this section will show, however, it may have limited applicability in some cases.

The double recovery argument applies most strongly to a case in which an injured person receives compensation for damages without paying premiums for the contractual right to receive the compensation. The double recovery argument would also be strengthened if this gratuitous compensation returns the injured person to the precise condition before the accident occurred. In such a case, the additional recovery from the tortfeasor would be a windfall to the injured person. There is no doubt that he has recovered twice for his injuries and has actually reaped a profit from becoming injured. If the only purpose of imposing liability on the tortfeasor was to fairly compensate injured parties, then additional compensation in such a limited case would be an inefficiency in

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116. See *supra* note 101 (comparing the creation of a collateral source setoff statute to the removal of tort liability as in the case of no-fault insurance plans).

117. See *supra* notes 25-28 and accompanying text.



the tort system. However, as this Note proposes, the allocative and deterrent purposes of the tort system must be considered when assessing the overall impact of this inefficiency argument in light of the collateral source rule debate.<sup>118</sup> It is possible that the inefficiency of a plaintiff's double recovery is met or exceeded by the benefits of the allocative and deterrent impact of imposing tort liability on the injurer. If so, then retaining the collateral source rule would be beneficial, even though it produces some compensation inefficiencies.

In addition, the increased use of subrogation or reimbursement rights by first-party insurers against tortfeasors, with a concerted effort to reduce the transaction costs of these arrangements, will significantly decrease the inefficiencies of double or multiple recovery by the plaintiff.<sup>119</sup>

Before subrogation is considered, this Part will focus on two factors that mitigate the double recovery inefficiency and decrease the likelihood of the existence of a perfectly and freely compensated plaintiff who has received a double recovery. These factors may help tip the balance so that the allocative and deterrent purposes of tort law outweigh the compensation inefficiencies. These factors are the nature of the insured's contract with the insurer and the extent to which tort damages can truly compensate for tort injuries.

#### A. *Benefit of the Bargain*

Critics of the collateral source rule contend that the rule turns the insurance contract into a wager of the premium for a chance at double recovery.<sup>120</sup> If an insured acted out of prudence and foresight in obtaining the insurance, then the only reasonable expectation would be to receive the insurance benefits and no more. The collateral source rule, however, allows insureds to add a tort judgment to their insurance benefits.

The main opposition to the wager-for-double-recovery argument is that the plaintiff's contract with the insurer is just that, a contract.<sup>121</sup> Since the private contract with the insurer is separate

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118. See *supra* notes 60-76 and accompanying text (discussing the allocation of resources purpose of tort liability); see also *supra* notes 77-116 and accompanying text (discussing the deterrence purpose of tort liability).

119. See *infra* notes 158-195 and accompanying text (discussing improvements to subrogation and reimbursement procedures).

120. See Brief of Amicus Curiae Defendant-Appellee at 22, *Sorrell v. Thevenir*, 633 N.E.2d 504 (Ohio 1994).

121. See Jacobsen, *supra* note 7, at 531-32 (pointing out that the plaintiff receives the

and distinct from the plaintiff's tort relationship with the tortfeasor, the plaintiff's right to recover damages from the tortfeasor via the legal process should not be disturbed by a collateral source setoff statute.<sup>122</sup> Of course, the plaintiff can also contract not to receive both the insurance proceeds and damages from the defendant via a subrogation or reimbursement clause in the insurance contract.<sup>123</sup> Since many insurers do include these types of clauses in their policies, it may seem a moot argument for the victim to assert the contractual right to receive both the insurance proceeds and damage awards. However, insureds prefer insurance contracts with subrogation costs due to lower premiums.<sup>124</sup> Therefore, the insured's right to choose which type of policy to enter into, to the extent that this is possible, is the right that is protected when the collateral source rule is retained.

Additionally, the insurer has already been paid, *ex ante*, by the plaintiff to provide benefits in case of injury.<sup>125</sup> If the defendant also has a liability insurer who will pay the damages to the plaintiff, then this insurer also has already been pre-paid. These insureds have both paid a premium equivalent to the amount the insurers must pay to the insureds, discounted by the risk of the loss occurring. This shifts the loss to the insurers. Insurance companies do business by assuming many risks of loss, with the knowledge that a majority of them will not materialize. Paying benefits to an insured when a loss occurs is simply a cost of doing this business. A collateral source setoff statute operates to relieve the defendant's insurer from paying the plaintiff's damages and the insurer is relieved of the duty of paying benefits for which the insurer has already been compensated and has previously contracted to pay.

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insurance benefits not because of the injury-causing accident, but because of the contract, paid for by the insurance premiums, which entitles him to the right to receive the benefits).

122. See John Barrow, *The Contracts Clause and the Collateral Source Rule*, TRIAL, July 1988, at 33, 36 (arguing that if the plaintiff's benefits are paid under a nonsubrogated insurance contract that was entered into before the statutory elimination of the collateral source rule, denying the plaintiff full damages would impair the plaintiff's vested property rights obtained when the insurance contract was executed). The flaw in this argument is that a setoff statute would not disturb the plaintiff's contractual right to receive insurance benefits, it would only disturb the plaintiff's tort rights.

123. See *infra* notes 139-157 and accompanying text (discussing subrogation). In fact, Shavell contends that both the insurer and insured will prefer insurance contracts with subrogation rights. See *infra* notes 149-152 and accompanying text.

124. See SHAVELL, *supra* note 68, at 235-40.

125. See LANDES & POSNER, *supra* note 63, at 252-53; POSNER, *supra* note 19, § 6.14.

The operation of a new collateral benefit setoff rule clearly gives the defendant's liability insurer a windfall that it did not expect when it wrote the defendant's liability insurance policy.

As mentioned earlier,<sup>126</sup> opponents of the collateral source rule contend that the insured is wagering with the pre-paid contract that he will be injured by a solvent tortfeasor, thus giving the insured a double recovery. Under the indemnity theory of insurance law,<sup>127</sup> insurance benefits should only compensate for the loss suffered by the insured. If an injured person has a claim against the tortfeasor for his loss, then the indemnity theory would hold that there were actually no losses for which the insurer should pay benefits. The indemnity theory arose with clear policy considerations against using insurance contracts as wagers since this would create an "evil" incentive to destroy property or lives in order to recover insurance benefits.<sup>128</sup>

Under this pure indemnity theory of insurance, in a system where the collateral source rule operates to give a double recovery for injuries, there is no doubt that an insured is wagering so he can receive both insurance benefits and damages from a tortfeasor. He would be foolish not to make this wager since there is always the possibility of being injured by an insolvent tortfeasor or in a true accident. Those opposed to the collateral source rule contend that insureds wager with insurance policies in order to receive double recoveries. This contention is not persuasive because it is a financial necessity to provide oneself and one's family with insurance coverage.

In addition, if an insured is said to be wagering with an insurance contract that the loss will occur, then it can also be said that the insurance company is wagering that the loss will not occur. Although both parties hope that the accident will not occur, only the insurance company is doing so through purely monetary objectives,<sup>129</sup> since a non-occurring loss is one less income statement debit entry for the company. In that sense, as between the two parties, the insurance company's wager is even more tainted than the insured's wager. The insured may be wagering on the contract,

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126. See *supra* note 120 and accompanying text.

127. See KEETON & WIDISS, *supra* note 28, § 3.1(c).

128. See *id.*

129. Even if the insured is wagering, he probably is not hoping to be injured due to a fear of pain and the inconvenience of recuperation.

but he is also buying security against monetary loss by shifting the risk of a loss to a party that is less risk-averse.<sup>130</sup>

### *B. Ability of Tort Damages to Compensate*

As has already been conceded,<sup>131</sup> if collateral benefits received by a victim fully compensate for damages, then the double recovery argument is fairly strong. The conditional assumption that the benefits were fully compensatory, however, is as strong and misleading. It is true that the pecuniary damages incurred, such as medical costs and lost earnings, can be fairly compensated through collateral sources. If a jury awards damages solely on the belief that the plaintiff suffered only previously compensated pecuniary damages, then the double recovery argument, in its strong form, would justify offsetting this award with collateral benefits received by the victim. The array of alternative damages potentially available to a plaintiff,<sup>132</sup> however, shows that the tort system recognizes that many other types of injuries can be incurred that are not traditionally covered by insurance benefits.<sup>133</sup>

In a case where the jury knew the exact cost of insured medical expenses incurred and provided a categorized award, it would be easy to determine the jury's intent and compute a setoff. The *Sorrell* case, however, is an excellent example of a setoff provision frustrating the intent of the jury. Ms. Sorrell was awarded damages for medical expenses, lost wages, and pain and suffering.<sup>134</sup> The

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130. See SHAVELL, *supra* note 68, at 186-205 (discussing the allocation of risk and the theory of insurance).

131. See *supra*, Section V, para. 2.

132. Such alternatives include damages for pain and suffering, loss of future earning capacity, loss of consortium by the family, and punitive damages. See RESTATEMENT (SECOND) OF TORTS §§ 905(b) and comment, 906(c), & 908.

133. These losses are very difficult to measure. See POSNER, *supra* note 19, §§ 6.11-12 (discussing damages for loss of earning capacity and for pain and suffering); SHAVELL, *supra* note 68, at 134 (discussing the difficulty of estimating nonpecuniary losses). The question of what value to place on human life or pain and suffering is a difficult one. It can be given to a jury to draw on its collective life experiences. See Ingber, *supra* note 64, at 778 & n.26 (stating that courts rely on juries to quantify such intangible injuries using their "enlightened conscience" and their "good sense and good judgment as men and women of affairs"). In contrast, this question can be totally ignored by the court and nothing is awarded. See POSNER, *supra* note 19, §§ 6.11-12 (explaining the difficulty of valuing the loss of future enjoyment of life, or hedonic damages, and loss of future earnings of children). It is clear though, that allowing juries to award nonpecuniary damage awards, even high awards, is a valued and traditional part of our tort system.

134. See *Sorrell v. Thevenir*, No. 91 CA 4, 1992 Ohio App. LEXIS 5098, at \*2 (Gallia Cty. Sept. 30, 1992).

sum of these damages was actually less than the amount of worker's compensation benefits she and her medical provider had received for her pecuniary losses only. It is difficult to understand how the jury handled Ms. Sorrell's pecuniary damages. If it is assumed, however, that they were not aware of the worker's compensation benefits she received, due to the inadmissibility of collateral benefits evidence, their low estimate of the cost of medical care is understandable. The jury's intent was clear, however, in that they wanted to award Ms. Sorrell \$5,000 for pain and suffering.<sup>135</sup> The effect of the Ohio setoff statute in this case would have totally setoff the sum of Ms. Sorrell's pecuniary and non-pecuniary jury awarded damages. This is true since the statute does not differentiate between or attempt to align the setoff between similar collateral insurance benefits and jury awards. The jury's pain and suffering award could have been nullified by the statute. Indeed, the plaintiff in *Sorrell* argued that the benefits should correspond to the jury awards that are being reduced.<sup>136</sup>

If a solution to the double recovery problem is still called for, a better setoff statute would more clearly align the insurance benefits received with the corresponding component of the jury award. If medical expenses or lost wages were paid by collateral sources, then the setoff for these benefits should only apply to a jury award that specifies these two types of damages. As the statute in Ohio was originally crafted, total collateral benefits are subtracted from total compensatory damages.<sup>137</sup> Since this could interfere with a jury's award of non-economic damages such as for pain and suffering, simply limiting the setoff to identifiable economic damage awards would solve the problem.<sup>138</sup> In the *Sorrell* case, if this limitation were imposed, the jury's pain and suffering award would have been left intact. Ms. Sorrell's \$15,000 of worker's compensation benefits would have only offset the jury award for medical expenses and lost wages and she would have received the \$5,000 in pain and suffering damages that the jury deemed that she had incurred. Unless an economic-award-only setoff provision is incor-

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135. *See id.*

136. *See* Brief of Plaintiff-Appellant at 11-15, *Sorrell v. Thevenir*, 633 N.E.2d 504 (Ohio 1994).

137. *See* OHIO REV. CODE ANN. § 2317.45(B)(2)(c)(i) (Banks-Baldwin 1995).

138. *See* CONN. GEN. STAT. ANN. § 52-225a (West 1991) (limiting the collateral source setoff to economic damages).

porated into these setoff statutes, the value of jury compensation for non-economic damages will be seriously compromised.

## VI. SUBROGATION & EFFICIENCY PROPOSALS

### A. Subrogation—Background

Subrogation has been recommended as a solution to the double recovery problem that arises under the operation of the traditional collateral source rule.<sup>139</sup> Subrogation is the legal or contractual right of an insurer to substitute itself in place of its insured in regard to some or all of the insured's rights to recover damages from the defendant.<sup>140</sup> In a case such as *Sorrell*, if the insurer providing benefits was subrogated to the plaintiff's right of recovery, the insurer could bring suit on its own behalf, or on behalf of the plaintiff, in order to recover damages from the defendant. The defendant would pay the benefits directly to the insurer as reimbursement for the insurance benefits paid to the plaintiff.<sup>141</sup> Hence, there would be no double recovery by the plaintiff and the insurance industry would have only paid one set of benefits to the victim. Specifically, the defendant's liability insurer would pay the tort judgment to the plaintiff's insurer. Extensive use of subrogation by insurers, along with continued operation of the collateral source rule, would solve the double-recovery problem and still promote the allocative and deterrence purposes of tort liability.

There are, however, a few difficulties with subrogation that result in it not being used without exception in insurance contracts. Traditionally subrogation has been limited to property insurance policies and has had limited application in personal medical bene-

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139. See Gary T. Schwartz, *A National Health Care Program: What Its Effect Would Be On American Tort Law and Malpractice Law*, 79 CORNELL L. REV. 1339, 1347 (1994) (presenting variations on the collateral source rule under possible future tort law regimes).

140. See KEETON & WIDISS, *supra* note 28, § 3.10(a)(1); see also Spencer L. Kimball & Don A. Davis, *The Extension of Insurance Subrogation*, 60 MICH. L. REV. 841 (1962).

141. See KEETON & WIDISS, *supra* note 28, §§ 3.10(b)(1), 3.10(c)(1) (discussing an insurer's right and ability to bring suit on its own or on the insured's behalf and various methods of allocating tort judgments to insured and insurer under a subrogation agreement).

fits policies.<sup>142</sup> Subrogation procedures are also extremely expensive in relation to the benefit they give to insurers.<sup>143</sup>

In spite of these problems, both supporters<sup>144</sup> and opponents<sup>145</sup> of the collateral source rule have offered subrogation as a solution to the double recovery problem. In light of the allocative and deterrent benefits presented in this Note that favor the continued use of the collateral source rule, the increased use of subrogation in conjunction with the collateral source rule would limit the double-recovery problem as well as preserve the benefits of the rule. Schwartz's call to investigate the feasibility of subrogation should be pursued in order to determine if the benefits of the collateral source rule justify retaining the rule.<sup>146</sup> This Note proposes that subrogation can be beneficial to insurers, insureds, and society as a whole due to the allocative and deterrence effects of full tort liability.

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142. See *id.* at § 3.10(a)(7) (explaining that subrogation rights were denied due to rules against the assignability of causes of action for injury to another person); see also Kimball & Davis, *supra* note 140, at 860-61 (explaining that the traditional objection to legal subrogation in medical benefit cases is that, absent an express contract provision, insurance of a personal nature cannot be subject to subrogation by the insurer). *But see* Smith v. Travelers Ins. Co., 362 N.E.2d 264, 265-66 (Ohio 1977) (holding that a subrogation clause is enforceable in a medical benefits case, and reflecting the trend towards allowing subrogation in these insurance contracts). *Smith* is representative of the trend towards including subrogation provisions in many medical insurance policies, including Blue Cross and Blue Shield plans. See KEETON & WIDISS, *supra* note 28, § 3.10(a)(7).

143. See Wilbur C. Leatherberry, *No-Fault Automobile Insurance: Will the Poor Pay More Again?*, 26 CASE W. RES. L. REV. 101, 150 (1975); see also Jeffrey O'Connell, *A Proposal to Abolish Contributory and Comparative Fault, With Compensatory Savings by also Abolishing the Collateral Source Rule*, 1979 U. ILL. L.F. 591, 604-05 (supplying selected subrogation cost statistics, showing the minute percentage of losses subrogation actually recovers for the insurer, and arguing for the elimination of subrogation due to the expense of the process).

144. See Schwartz, *supra* note 139, at 1347 (calling for further investigation into the costs and application of subrogation rights).

145. See Gobis, *supra* note 13, at 890; Schafer, *supra* note 23, at 590. In fact, Ohio R.C. § 2317.45 provides exemption from the setoff statute to plaintiff's insurers who have legal or contractual "rights of recoupment" from the defendant. OHIO REV. CODE ANN. § 2317.45(B)(2)(a)-(b) (Banks Baldwin 1995). This preserves the subrogation rights of the insurer and recognizes the ability of these rights to limit the double recovery. *But see* 2 ALI REPORTERS' STUDY, ENTERPRISE RESPONSIBILITY FOR PERSONAL INJURY 170-71, 177-82 (1991) (arguing that the use of subrogation, with or without a traditional collateral source rule, is prohibitively expensive and difficult to enforce due to legal and practical restraints).

146. See Schwartz, *supra* note 139, at 1348-49 (criticizing the ALI REPORTERS' STUDY, *supra* note 145, as "premature in writing off . . . subrogation" and inviting regulators and scholars to continue a cost/benefits analysis of subrogation).

On a theoretical level, the argument that subrogation is beneficial is well supported. Posner contends that insurers should be able to contract for the right to be reimbursed for benefit payments made to their insureds when the insured has recoverable rights against a third party.<sup>147</sup> In addition, the insurers could demand that the insured assign her legal rights against the tortfeasor to the insurer.<sup>148</sup>

Shavell agrees and, in fact, contends that both insurers and insureds will prefer insurance contracts giving subrogation rights to the insurer.<sup>149</sup> This is so because the existence of subrogation rights in insurance policies is socially optimal. Insureds as a group will gain more utility from lower premiums than from a few possible double recoveries from defendants and insurers will be able to recover portions of the judgment from the defendant.<sup>150</sup> In addition, an insurer's subrogation rights will prevent inappropriate incentives for the insured to cause or fabricate losses to effect a double recovery.<sup>151</sup> Shavell recognizes the limitations of legal restraints on subrogation, the doubt that it actually lowers premiums, and the increased transaction costs due to a rise in subrogation litigation. He argues, however, that these constraints work against both the insured and insurer.<sup>152</sup> In light of the efficiency gains of subrogation to both parties that Shavell discusses, both parties have incentives to overcome these limitations.

The general legal constraints against subrogation in health and medical insurance policies are eroding.<sup>153</sup> Clauses granting such rights to insurers are becoming more and more common in other types of insurance policies. In fact, there is even some support for allowing subrogation to life insurers,<sup>154</sup> an area that has tradition-

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147. POSNER, *supra* note 19, at § 6.13 (arguing that premiums would be less where the insured would be required to assign any legal rights from the injury to the insurer).

148. *See id.*

149. *See* SHAVELL, *supra* note 68, at 235-40.

150. *See id.* at 236.

151. *See id.* at 237.

152. *See id.* at 237-38 (arguing that the increased cost of litigation and transaction costs due to subrogation litigation is a problem that may be difficult to resolve, but that these are not inherent problems of subrogation; rather, they are a reflection of the justice system as a whole).

153. *See supra* note 142.

154. *See* George S. Swan, *Subrogation in Life Insurance: Now is the Time*, 48 INS. COUNSEL J. 634 (1981).



ally disallowed subrogation.<sup>155</sup> The increased use of subrogation clauses would obviate the need for collateral source setoff statutes and allow for free operation of the collateral source rule without the maligned double-recovery problem.

Given the support of economic theory and relaxation of subrogation's legal constraints, the problem on a more practical level is how to promote the efficient use of subrogation. If the costs of subrogation are too high, or if its use is limited, then the benefits of imposing full liability on tortfeasors and their insurers will be outweighed by the costs of subrogation and the continued inefficiency of double recovery. If Professor Schwartz' mandate to investigate the costs and benefits of subrogation before completely eviscerating the collateral source rule is to be followed,<sup>156</sup> then serious attempts to install a cost-effective and pervasive subrogation program should be undertaken. This Note proposes that a statutory solution can address the inefficiencies of tort compensation through enforcement of subrogation rights. Without statutory impetus, or at least a consideration of the policies underlying such a proposal, insurers will not have the incentive to push subrogation as a solution to the double-recovery problem. Instead, insurers will rely on the expensive and spotty process that is now in place. Pointing to the "evils" of double recovery and the costs of the current subrogation practice, insurers instead will continue pushing for statutory revision of the collateral source rule and other tort reform measures.

Set out below are the various issues to be considered and addressed by a statutory reform of subrogation procedures.<sup>157</sup> The main topics to be addressed include coordination between plaintiff and defendant's insurers, allocation of subrogation recovery between plaintiff and his insurer, attorney's fees, mandatory arbitration, and possible procedural changes to combine arbitration with speedier subrogation recovery by first-party insurers.

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155. See KEETON & WIDISS, *supra* note 28, § 310(a)(6).

156. *Supra* note 146 and accompanying text.

157. This proposal only generally addresses these issues. Different insurance programs such as worker's compensation, social security, Medicare/Medicaid, automobile, medical and health, malpractice, and general liability may require individualized analysis.

### B. Coordination of Tort Judgment or Settlement

Before an injured insured even enters the tort system, the inefficiencies of compensation have already been encountered. In many cases, a victim may be over-compensated by excess insurance coverage or by insuring with more than one insurer.<sup>158</sup> The multiple-compensation problem is mostly addressed by insurers' increased use of "Other Insurance" clauses. Until multiple recoveries from different insurers are eliminated, however, the insurance industry can hardly complain of the tort system's double-recovery problems.

Insurer's attempts to coordinate insurance benefits can easily be adapted and applied to the enforcement of subrogation agreements by the insurer against other insurers.<sup>159</sup> The legal mechanisms that promote the coordination of insurance benefits and contractually limit coverage for the benefit of the insurer can similarly be used to give the insurer the contractual right to recover part of the tort judgment. These mechanisms are already in place in insurance policies that include subrogation clauses. However, the problem of promoting the information exchange and extending the use of these provisions remains.

An objection to relying on subrogation as a remedy for double recovery, even when it is permitted by law and included in the insurance contract, is that monitoring lawsuits and securing reimbursement at their conclusion is too expensive. This precludes

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158. See KEETON & WIDISS, *supra* note 28, § 3.11(d) (discussing the reluctance of courts to deny insureds multiple coverage and basing this tendency on policy borrowed from the traditional collateral source rule). However, the trend is increasingly towards enforcing insurers' "Other Insurance" clauses which serve to limit multiple coverage. See *id.* § 3.11(a)(1) & (d); see also Kenneth S. Abraham & Lance Liebman, *Private Insurance, Social Insurance, and Tort Reform: Toward a New Vision of Compensation for Illness and Injury*, 93 COLUM. L. REV. 75, 94-98 (1993) (describing the United States system as a web of various compensation schemes, including both cause- and fault-based systems, with a complex coordination of benefits between the different systems based on these types of clauses).

159. See Abraham & Liebman, *supra* note 158, at 116 (linking the loss compensation system to a cost-accounting mechanism which simply bundles its claims for reimbursement against liability insurers for more efficient loss-cost transfer). The proposal to more closely enforce subrogation rights just as multiple insurance provisions are enforced may have limited applicability where the insurer is actually involved in the tort dispute. In that case the resolution of fault issues will force the insurer to incur litigation costs that probably exceed those found in "Other Insurance" clause disputes. However, multiple insurance disputes which require dispute resolution are also common. See KEETON & WIDISS, *supra* note 28, § 3.11(d).

enforcement in cases involving small sums.<sup>160</sup> As inefficient as small-claims enforcement may be, it does not change the fact that the mechanisms that monitor and prevent double insurance coverage could just as easily be used for subrogation monitoring purposes as well. The costs involved in monitoring tort suits would seem to parallel, and not exceed, the monitoring costs for double insurance coverage. The cost/benefit ratio of enforcing subrogation rights for small sums would probably be similar to enforcing "Other Insurance" clauses; this is something that the industry seems perfectly willing to do.

If the goal of increased subrogation is to decrease double recovery costs to the industry, then defendants' liability insurers, who often also write first-party coverage, will have an economic incentive to cooperate and ensure that the plaintiff's insurer is reimbursed. Offsetting this cooperative incentive is a collusive incentive between the defendant's insurer and the plaintiff to preclude the plaintiff's insurer's subrogation rights by entering a secret settlement. By not notifying the plaintiff's insurer of the settlement, the two parties could divide the subrogation recovery among themselves. The defendant's insurer would pay out less and the plaintiff would receive more under this secret settlement.

In order to promote the reimbursement of the plaintiff's insurer and to avoid this type of collusion, a statutory escrow or trust arrangement could be utilized.<sup>161</sup> The liability insurer would hold the portion of the judgment or settlement corresponding to the benefits paid by the insurer.<sup>162</sup> In addition to the overall economic incentives of full reimbursement, statutorily requiring a liability insurer to hold that portion of the judgment deemed pecuniary would give the liability insurer the incentive to investigate any pending subrogation rights. This investigation would not necessarily be extensive, and placing the burden of a reasonable inquest on the escrow agent would avoid any possibility of collusion.

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160. See 2 ALI REPORTERS' STUDY, *supra* note 145, at 170.

161. See *id.* at 178-80 (questioning the desirability of this arrangement due to possible conflicts of interest among the parties). But if the industry-wide interest in promoting subrogation is considered, the defendant's insurer will be more likely to participate in this type of arrangement on a reciprocal basis among all insurers.

162. In order for the escrow agent to be able to retain the judgment or settlement proceeds for the first-party insurer's recovery, the judgment or settlement would have to resemble a jury special verdict form. The award would have to be specifically segregated into pecuniary (reimbursable) and nonpecuniary damages.

If the defendant's insurer does not fulfill this imposed duty, the plaintiff's insurer's remedy would be full reimbursement from the defendant's insurer regardless of whether the plaintiff had received funds nominally representing the plaintiff's insurer's subrogation fund. This remedy is consistent with placing the investigatory and escrow burden on the defendant's insurer. Before entering into a settlement with the plaintiff, the specter of paying twice for the compensatory damages, once to the plaintiff and again to the plaintiff's insurer, will cause the defendant's insurer to investigate the existence of subrogation rights of the plaintiff's insurer.

### *C. Allocation of Tort Judgment or Settlement*

Once the industry has protected itself against multiple payments through a pervasive coordination of benefits program, and the subrogation funds are held in escrow, the question will remain as to how to allocate these funds among the insurer, the insured, and the insured's attorney.

Of course, the first-party insurer will have an interest in recovering the full amount of medical expenses or lost wages paid. This may not be a problem in jury trials where these items are often presented to the jury for easy inclusion in a special jury verdict. The more difficult problem is in the settlement arena where the negotiations often involve total dollars and not categorical damages.<sup>163</sup> In that case, if a settlement is reached for less than the plaintiff's claimed total damages, including pain and suffering, then reimbursing the insurer for total benefits paid would leave the plaintiff's pain and suffering damages less than fully compensated. Conversely, reimbursing the insurer with only a portion of total benefits paid would not give full effect to the subrogation agreement.<sup>164</sup> In the interest of facilitating administration and predictability, these types of allocation conflicts should be resolved either by the insurance contract subrogation agreement or by statute.

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163. See 2 ALI REPORTERS' STUDY, *supra* note 145, at 180 (discussing the settlement with subrogation conflict and suggesting that there is no suitable solution); see also KEETON & WIDISS, *supra* note 28, § 3.10(b)(1)-(4) (outlining three main subrogation allocation methods, suggesting that not one of the three is used predominately, and indicating that the result reached is often a compromise between the insurer and insured).

164. See 2 ALI REPORTERS' STUDY, *supra* note 145, at 180.

There are three basic methods for allocating recovery when the total settlement fund is not sufficient to reimburse the insurer and fully compensate the plaintiff: (1) insurer reimbursement first; (2) proration of third party recovery between insurer and insured in proportion to percentage of total original loss compensated by the insurer; and (3) insured reimbursement for total loss first.<sup>165</sup> A simple example should illustrate these methods more clearly. As a result of a third-party's negligence, a victim incurred \$10,000 of insured medical expenses and \$20,000 in pain and suffering. If the plaintiff settled the claim for a flat \$20,000, then under the first allocation option the insurer would be fully reimbursed and the victim would be undercompensated by \$10,000. The second option, proration of the \$20,000 settlement fund, would give one-third to the insurer and two-thirds to the victim.<sup>166</sup> Under the third option, the victim would be fully compensated, but the recovery fund would be fully depleted, barring the insurer's recovery.

None of these solutions is satisfactory in light of the conflict between full compensation and subrogation recovery mentioned above. The second option, proration, may intuitively be the best solution since in the absence of an express contract provision it would be the most likely result of an arm's-length negotiation between the parties.<sup>167</sup> A problem arises, however, due to the difficulty in measuring the relative value of the insured's pain and suffering damages at the settlement stage without the jury's verdict.<sup>168</sup> As a result of this difficulty, the plaintiff will have an incentive to overstate a claim for these damages to obtain a greater share of a proration allocation.

In order to avoid the inevitable conflicts of interest and disputes between insurer and insured over the intangible damages, the first allocation method, fully reimbursing the insurer first, should be used. Not only does this eliminate any possible conflicts and provide full subrogation recovery, it also recognizes that medical costs are much more definite and predictable than pain and suffering damages. These damages may turn on the whim of a jury or

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165. See KEETON & WIDISS, *supra* note 28, § 3.10(b)(1).

166. The one-third/two-thirds proration results from the original ratio of benefits received to total injury (20,000/30,000).

167. See KEETON & WIDISS, *supra* note 28, § 3.10(b)(1).

168. See *supra* note 162 and accompanying text (discussing the necessity of jury special verdicts specifically segregating the award into pecuniary and non-pecuniary damages).

the settlement negotiation prowess of the plaintiff's attorney. Statutorily providing for this option will further streamline the subrogation process from a dispute standpoint and create foreseeable and certain results.

#### *D. Attorney Fees*

Another problem that will arise when an insurer seeks reimbursement from a tort judgment or settlement relates to the exact amount that the insurer should expect to receive. The insurer will claim the full amount of the benefits it paid to the insured. If the plaintiff's attorney has done all of the work in obtaining the award, however, he will certainly demand a reasonable fee. If this fee demand is paid, it will most likely decrease the insurer's recovery. This creates a conflict between the basic goal of fully reimbursing the insurer from the tort judgment and giving the plaintiff, or more likely his attorney, the incentive to essentially do the insurer's job of subrogation recovery.

These opposing goals are difficult to balance. If the insurer is fully reimbursed, then it has received a windfall from the plaintiff's attorney's hard work. This is a windfall because the insurer would have expended its own legal costs to obtain the subrogation recovery if the insured had not retained his own attorney. In the interest of the overall goal of streamlining the process of subrogation, there is no reason that this problem has to be left to hardball negotiations between the insurer and the plaintiff's attorney. The fee rate for subrogation recovery to be paid by the insurer can be set out in the subrogation clause of the insurance contract or it can be statutorily mandated.<sup>169</sup> The fee for this type of arrangement could be set at a "reasonable" level to correlate with the level of the plaintiff's attorney's fees in that case. On the other hand, in the interest of providing fuller reimbursement, the rate could be a lower set rate, ranging from ten to twenty percent. It may seem like the plaintiff's attorney is unjustly benefiting from any added fee, but if it is realized that the insurer would have to expend

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169. See, e.g., VA. CODE ANN. § 65.2-311 (Michie 1995). This Virginia Worker's Compensation statute provides that the attorney's fees for subrogation recovery by the plaintiff on behalf of the insurance carrier are to "be apportioned pro rata between the employer [insurer] and the employee." § 65.2-311. If a plaintiff's attorney's standard fee is one-third of the recovery, then the insurer's subrogation recovery is decreased by one-third.

similar amounts to recover on its own, then the fee-shifting onto the insurer is just.

### *E. Arbitration*

The discussion to this point has assumed that the insurer is not actively involved in the plaintiff's lawsuit. This may not be very realistic since in a limited number of cases with large subrogation recoveries at stake the insurer will be directly involved with the litigation or settlement process to protect its own interests.<sup>170</sup> This scenario may create many problems including conflicts of interest between the insurer and insured. However, the problem to be addressed is containing subrogation costs. With the addition of the insurer/subrogee, these costs now include direct litigation costs. These costs are a burden on the insurer and should only be viewed as a detriment to the subrogation process. It may seem that since the insurer is enforcing its right to recover sums from the defendant, the insurer should bear the burden of finding ways to limit these costs or to more economically make the decision whether to become involved in the litigation.<sup>171</sup> The goal, however, is to encourage more subrogation through more efficient processes. If the insurer needs to be involved in the litigation, then faster, more efficient methods should be used so as to decrease the total subrogation costs.

Arbitration and other forms of alternate dispute resolution are commonly used in insurance litigation.<sup>172</sup> Arbitration agreements between insurers provide many benefits including quicker resolution of conflicts, lower costs than standard trials leading to lower insurance premiums, more informal settings that provide a more conducive atmosphere to conflict resolution, and an easing of the

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170. "[A]sserting a subrogation right is usually viewed as 'standing in the shoes' of the insured so that the insurer's rights are equal to, but no greater than, those of the insured." KEETON & WIDISS, *supra* note 28, § 3.10(a)(1).

171. In the litigation setting, the plaintiff's insurer may be at the mercy of the defendant's insurer in terms of limiting costs and speeding up the process. However, intra-industry cooperation via information exchange and statutory escrow agents, and the realization that the insurers are repeat players in this context should lead to a more efficient process. See *supra* notes 158-162 and accompanying text.

172. See William K. Jones, *Strict Liability for Hazardous Enterprise*, 92 COLUM. L. REV. 1705, 1732 n.135 (1992) (indicating that informal inter-company settlement procedures are used extensively in automobile collision litigation); Schwartz, *supra* note 139, at 1348 (stating that major Southern California auto insurers have entered into an "intercompany arbitration agreement" to keep down costs on subrogation claims).

caseloads of overburdened courts.<sup>173</sup> Clearly, arbitration of disputes involving subrogation recoveries by insurers has benefits in excess of simply reduced litigation costs. Arbitration is not cost-free, however, and these costs must be taken into account when making the subrogation cost/benefit analysis.

Arbitration between insurers can be statutorily mandated.<sup>174</sup> When arbitration is required, whether in all cases or under a threshold-type statute such as New York's, insurers will have more incentive to efficiently utilize the process to their advantage. As repeat players in such an informal setting, with the added possibility that the same insurer may have both subrogation payouts and recoveries in the same venue, the arbitration option is ideal for encouraging the intra-industry cooperation needed to reduce subrogation costs.

#### *F. Arbitration Plus Allocation of Tort Judgment or Settlement*

As discussed earlier, the allocation of an award between insured and an insurer with subrogation rights can be fraught with difficulties.<sup>175</sup> The case becomes even more complicated when the insurer is a party to the litigation. Whether in early negotiation, arbitration, or even at trial, the insurer's interests may conflict with those of the insured. Depending on the method of recovery allocation used, the insurer may be more or less willing to settle than the insured.<sup>176</sup> This conflict is especially acute when the plaintiff is seeking large pain and suffering damages from the defendant. The plaintiff is less concerned about the subrogation recovery since that money will be paid to the insurer in either case.<sup>177</sup> If the

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173. See Gerald Asken, *Arbitration of Automobile Accident Cases*, 1 CONN. L. REV. 70, 71, 76-78 (1968); see also ARBITRATION: COMMERCIAL DISPUTES, INSURANCE, AND TORT CLAIMS 215-341 (Alan Widiss ed. 1979) (discussing both policy and practical considerations of arbitration for various types of insurance and tort disputes).

174. See, e.g., N.Y. INS. LAW § 5105 (McKinney 1985) (including a section of the motor vehicle insurance statute entitled "Settlement between Insurers" and providing arbitration as the sole subrogation recovery remedy for the payer of first-party benefits against the insurer of the third-party tortfeasor). This New York statute also implements a threshold where arbitration is only available if the defendant was driving a truck over 6500 pounds or a bus. See § 5105.

175. See *supra* notes 163-169 and accompanying text.

176. If insurer first, then the insurer will quickly settle. If insured first, then the insurer will press the litigation on until it reaches full compensation.

177. The plaintiff would be concerned if an insurer-first or proration-allocation method was being used and the judgment or verdict possibilities seemed below actual damages because the plaintiff would be undercompensated in those cases.



plaintiff seeks pain and suffering damages, and the insurer reimbursement, then the plaintiff's interests could be compromised. This may happen if the insurer's attorney was also representing the plaintiff, or if the insurer's attorney was controlling the case.

In this scenario, it makes sense to bifurcate the proceeding into a insurer's cause of action for subrogation recovery and a plaintiff's cause of action for pain and suffering damages. The insurer's action would be statutorily limited to mandatory, non-binding arbitration.<sup>178</sup> The plaintiff would have the option of utilizing the same arbitration proceeding, a separate arbitration panel, or resorting to a traditional trial resolution.<sup>179</sup>

### 1. Benefits of Arbitration and Bifurcated Proceedings

The benefits of bifurcating the proceedings and more fully utilizing arbitration would include the possibility of full and speedy subrogation reimbursement. It would be simple for the insurer to prove the amount of benefits paid to the insured. In the arbitration setting, in addition to the normal arbitration savings, procedural relaxations would reduce evidentiary proof to the simple introduction and verification of the insurer's benefit payments. Since the insured is not involved in this proceeding, except possibly as a witness, the conflict of interest consideration would not come into play. There would be no award allocation problems since the insurer would directly receive reimbursement for benefits paid. Also, the insurer would not have to pay the insured's attorney fees for obtaining the recovery. Undoubtedly, the insurer will have its own legal fees; however, in-house counsel would surely cost the insurer less than the plaintiff's attorney.

The plaintiff would also benefit from this arrangement. First, the potential absence of the insurer from whatever option the plaintiff chooses would eliminate the conflict of interest problems for the plaintiff as well. The plaintiff and his attorney would be free to

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178. See *supra* notes 172-74.

179. This option prevents violating the plaintiff's constitutional right to a jury trial or equal protection rights. See, e.g., U.S. CONST. amend. VII; OHIO CONST. art. I, § 5. Although mandatory, non-binding arbitration has been found to be constitutional, requiring only the insurer to submit to arbitration sufficiently addresses the need to reduce subrogation costs. See, e.g., *Beatty v. Akron City Hosp.*, 424 N.E.2d 586 (Ohio 1981) (holding Ohio's medical malpractice mandatory arbitration statute, OHIO REV. CODE ANN. § 2711.21 (Baldwin 1981) (amended to non-mandatory in 1987), constitutional against due process and equal protection challenges).

determine the viability of the suit without outside pressure from the insurer.

Second, the plaintiff could also benefit from the parallel proceeding in his own arbitration or trial. The plaintiff's compensatory damages would have already been established in the insurer's arbitration. The plaintiff could use the already proven damages at the later trial to help establish the underlying basis for his nonpecuniary damages. As a result of the bifurcated causes of action, the plaintiff would be barred from recovering these compensatory damages.<sup>180</sup> In addition, since the arbitration proceeding would presumably have included a fault determination by the arbitrators, this determination could potentially be introduced as evidence at the jury trial.<sup>181</sup> With both compensatory damages and fault established, the plaintiff's proceeding would be even more streamlined and consist mainly of a trial for nonpecuniary damages.

Third, not losing sight of the larger picture, if subrogation is streamlined by this procedural bifurcation, all insureds should theoretically benefit from lower premiums. This is simply a corollary benefit from the increased efficiency of arbitration.<sup>182</sup>

## 2. Problems with Arbitration and Bifurcated Proceedings

Bifurcated proceedings and additional arbitration would surely have their difficulties. Obviously, adding another layer of litigation seems counter-intuitive to the goal of reducing costs and streamlining the subrogation process. However, this may only apply to the overall cost of litigating the entire dispute. The costs relating to the actual insurance subrogation will be greatly reduced by limiting it to early arbitration. The cost to the plaintiff of independently mounting an additional lawsuit may add another layer with some duplicative costs. But if the plaintiff can utilize the compensatory damage and fault findings from the earlier arbitration hearing,<sup>183</sup>

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180. It may be beneficial to allow the plaintiff to present the compensatory damages as if the plaintiff were trying to recover them. This recognizes the evidentiary concerns raised in traditional collateral source rule operations. *See supra* notes 7-8 and accompanying text. If successful, the plaintiff would simply deduct this amount from the verdict before the defendant paid the award.

181. It is also possible that the issue of fault could be conclusively determined at the arbitration. The plaintiff would not have to reprove the issue; the defendant could simply stipulate to the earlier finding. *See infra* notes 184-195 and accompanying text (discussing collateral estoppel concerns).

182. *See supra* note 173 and accompanying text.

183. *See supra* note 181 and accompanying text.

not all the costs will be duplicative. In addition, without the presence of his insurer and the possible conflicts of interest, it will be easier for the plaintiff to decide whether to further pursue the defendant.

As the plaintiff attempts to utilize findings from the prior proceedings in his own trial, the procedural hurdle to overcome is collateral estoppel.<sup>184</sup> An underlying policy of collateral estoppel is to reduce litigation costs by preventing multiple litigation on the same issue. Generally, collateral estoppel would work to the benefit of the plaintiff in this type of case. The plaintiff would offensively assert collateral estoppel to prevent relitigation of the issues determined in the arbitration.<sup>185</sup> Precluding relitigation of these issues would clearly fulfill the primary policy of collateral estoppel: reducing litigation costs and increasing subrogation efficiency.

Before the plaintiff can successfully assert collateral estoppel, a number of aspects of the proposed bifurcated proceeding, which cut against allowing collateral estoppel, must be addressed. First, in order to preclude the liability insurer from relitigating the fault issues, the burden of proof and the rigidity with which factual findings are made must be the same between the two proceedings.<sup>186</sup> Clearly this requirement is not satisfied as between a traditional arbitration hearing and a full jury trial. An arbitration hearing has more relaxed evidentiary procedures, and the arbitrators tend to make compromised determinations that blur factual determi-

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184. The law of collateral estoppel precludes the relitigation of matters that have already been determined in order to preserve judicial resources, foster reliance on the finality of judicial decisions, and reduce the possibility of inconsistent decision. See JACK H. FRIEDENTHAL ET AL., CIVIL PROCEDURE § 14.9 & n.2 (2d ed. 1993) (quoting *Montana v. U.S.*, 440 U.S. 147 (1979)). There may be a question of whether a non-judicial proceeding such as arbitration is subject to collateral estoppel. Arbitration findings, however, have often been subject to the doctrine. See G. Richard Shell, *Res Judicata and Collateral Estoppel Effects of Commercial Arbitration*, 35 UCLA L. REV. 623, 649 (1988).

185. In a bifurcated proceeding such as the one proposed, if the defendant's liability insurer received an unfavorable fault determination in the arbitration proceeding, he would attempt to relitigate the issue of fault before the jury in the later proceeding. The offensive use of collateral estoppel by the plaintiff, however, would prevent the defendant and the defendant's insurer from relitigating an issue that had already been determined. See *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 326-32 (1979) (distinguishing offensive and defensive collateral estoppel, promoting the use of offensive collateral estoppel when judicial efficiency was not harmed, but warning of possible abuse by plaintiffs who vexatiously increase litigation via the use of collateral estoppel).

186. See FRIEDENTHAL, *supra* note 184, § 14.10.

nations.<sup>187</sup> A full jury trial, on the other hand, consists of the familiar onerous evidentiary procedures. However, the distinctions between the two types of proceedings can be decreased by requiring the arbitrator to make more rigid evidentiary findings and to clearly state the basis for those findings.

Second, under the collateral estoppel doctrine of mutuality, only parties involved in the prior proceeding may take advantage of its determinations.<sup>188</sup> Since the plaintiff was not a party to the arbitration, this would seem to allow the liability insurer and the defendant to relitigate the issues of fault and even damages. However, adherence to the doctrine of mutuality has been eroding steadily as many courts have expanded the notion of privity to enable a greater binding effect of the prior determination.<sup>189</sup> Parties are deemed to be in a privity relationship when they have interests which are so intertwined that a decision involving one should necessarily bind or benefit the other.<sup>190</sup> This enhanced view of privity requires an analysis into whether the non-party's interests were fully represented in the prior proceeding.<sup>191</sup> In the proposed bifurcation, the likely similarity of interests (both parties have similar interests in damages and fault) indicates that plaintiff and the plaintiff's insurer should have privity.<sup>192</sup> The plaintiff will be able to take advantage of the prior damage and fault determinations by offensively asserting collateral estoppel against the defendant and the defendant's insurer.

Identity of interests between plaintiff and insurer does not fully satisfy a proposal to grant privity to the plaintiff in order to utilize the previous findings. Arbitration is significantly different from litigation in that the fact-finding process can vary widely and the arbitrator's findings are often "unexplained and difficult to

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187. See Shell, *supra* note 184, at 632-33.

188. See FRIEDENTHAL, *supra* note 184, § 14.14. Collateral estoppel can benefit parties (such as the plaintiff in this case) or it can bind a party to a previously adverse finding (such as the defendant here). The defendant cannot assert that he cannot be bound because he is a party to both proceedings. The defendant can only assert that the plaintiff should not benefit since the plaintiff was not involved in the prior proceedings.

189. See *id.*; see also *Parklane Hosiery*, 439 U.S. at 328 (approving the use of collateral estoppel in case where strict mutuality requirements are not met).

190. See FRIEDENTHAL, *supra* note 184, § 14.13.

191. See *id.* § 14.13-14.

192. An insured will not want privity with the insurer when the arbitration findings are adverse since the plaintiff will be bound by the findings. However, the plaintiff should not be able to choose when he is or is not bound by the arbitration proceedings.

interpret."<sup>193</sup> The defendant and liability insurer will certainly object to the use of these findings in a later proceeding where they can present the same evidence to a jury and subject it to more rigorous screening processes. These are important differences and ideally the gap between the two processes should not be so wide. However, the policy considerations of decreasing litigation costs and determining these issues early<sup>194</sup> outweigh any prejudice to the defendant.

In addition, the policies that support utilizing arbitration to reduce subrogation costs also clearly support precluding costly relitigation on the same issues in a later trial. The defendant's insurer may argue that he is prejudiced by this preclusion. However, if the cooperative interests in seeing subrogation costs reduced are recognized, then the defendant's insurer will also want to conclude the issue as early as possible through collateral estoppel issue preclusion.<sup>195</sup>

Since the insurer's sole subrogation remedy of arbitration has already been established, there are few other substantial statutory provisions required to effectuate this bifurcation. The plaintiff's right to continue on his own behalf is well-settled, and the procedural issues of collateral estoppel are best left to judicial determination and party negotiation as outlined above.

Since entering the subrogation process in the first place is discretionary in cases where the insurer determines it would be uneconomical to recover small amounts or where the defendant's fault was in serious doubt, the insured's claim against the defendant for insured compensatory damages would be valid until the insurer's subrogation rights had been settled by arbitration. This will return the proposal to the traditional starting point: the plaintiff

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193. Shell, *supra* note 184, at 659.

194. *See id.* at 660 (explaining that these fundamental interests are shared by both the arbitration and litigation systems).

195. Arbitration is essentially a contractual issue even if mandated by statute. *See id.* at 661-63. The defendant's and plaintiff's insurers will have an interest in agreeing on the extent to which each side will be bound in the later proceedings. Recognition of these contract principles provides great flexibility to a court to delve into the intent of the parties as to whether certain issues would be precluded by the arbitration. Since, theoretically, both parties to the arbitration are interested in reducing the total costs of subrogation, this flexibility will be utilized by the parties to achieve this cost reduction by limiting issue relitigation as much as possible. *See id.*

will be able to bring suit for full pecuniary and nonpecuniary damages, just as with the traditional collateral source rule.

#### CONCLUSION

This Note discusses whether the collateral source rule is justified in light of modern theories of tort law. In recent years the rule has received much attention from commentators since it seemed antiquated and at odds with the evolving theory of tort law. In addition, the insurance industry has lobbied the state legislatures to ease the burden on the industry and help control runaway liability insurance premiums. The collateral source rule was an easy target for these initiatives. Moreover, the public perception that plaintiffs were receiving exorbitant damages awards, due in part to the rule, led to the passage of many tort reform packages that eliminated the collateral source rule. The rule was replaced with setoff provisions by which defendants could reduce their liability by the amount of insurance received by the plaintiff.

The collateral source rule debate is hardly over. Many states have not changed the traditional rule and some that have changed it have had the statute overturned by state supreme courts. Parties to this debate should take a more careful look at the purposes of the tort system and the large impact a change in the collateral source rule will have.

This Note presented three main areas of consideration in support of retaining the rule. First, if the collateral source rule is changed, the ability of society to effect, via price mechanisms, the correct levels of safe or valuable behavior will be impaired. Second, the notion that the deterrent impact of tort liability is outdated and serves no purpose in modern society is no longer uncontested in the current literature. Empirical evidence, while still hotly debated, shows that the deterrent impact of tort liability still has a place in the modern tort system. Third, a collateral source setoff provision can seriously impair the rights of injured parties to enjoy the contractual benefits of insurance as well as their rights to be compensated completely and effectively by the tort liability system.

In recognition of the conflict between the benefits of the collateral source rule and the drain on the insurance industry caused by overcompensated plaintiffs, this Note proposes a pervasive program of increased use of subrogation. Subrogation is currently used by insurers to reduce their costs, and its efficiency can also be used to reduce the costs of overcompensation. If subrogation can

be utilized to its full potential, then the collateral source rule can survive tort reform and the benefits of placing full tort liability on the parties that cause injuries can be retained.

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