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COMMENTS ON LANDES AND POSNER: A POSITIVE ECONOMIC ANALYSIS OF PRODUCTS LIABILITY

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LANDES and Posner have certainly delivered on their promise to give us a provocative paper. Their contention is that "the principal doctrines of products liability law are consistent with the hypothesis that the common law is best understood as an endeavor (which need not be conscious) to promote economic efficiency" in the sense in which they use that term.[1] Their definition of economic efficiency involves providing efficient incentives for injury prevention and some informal concern for the costs of transacting and litigation, but no concern for efficient bearing of risk. If their conclusions were widely held, we probably would not be here today.

Although their ingenuity is impressive, I find their conclusions less than compelling. My objections fall into three categories. The first is methodological. The second is the treatment of information costs. I think they overstate the information problem facing consumers and underestimate the information problems created for courts, producers, and insurers, by the rules designed to solve the consumer information problem. Third, even if they had shown that the common law tends to be efficient by their criterion of efficiency, I would argue that this criterion is too narrowly defined. Because it excludes costs of risk bearing, it cannot be used either as the basis of normative statements about what courts should do, if the goal is efficiency, or for positive statements about how the courts would behave if they were moved to act efficiently. Let me now discuss each of these issues in some detail.

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[1] William M. Landes & Richard A. Posner, A Positive Economic Analysis of Products Liability, in this issue, at 535.

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I. Methodology

Although Landes and Posner start with a formal model and then discuss empirical evidence, this is no strict application of the paradigm of scientific method, which would have one posit a theory, derive hypotheses, and then test the resulting predictions. The formal model, with perfect information and zero contracting costs, implies that relying on private contract is the efficient solution. To justify the overruling of contract by strict liability, Landes and Posner invoke imperfect information of consumers and high contracting costs. Granted, these costs exist. But giving up contract also entails costs—the costs of imposing uniform quality standards and uniform compensation on consumers who are presumably heterogeneous in their capacity for care and preferences for risk. So while information costs are necessary to undermine the case for contract, they are not sufficient to guarantee that tort is the more efficient alternative. It is an empirical question that cannot be resolved simply by appeal to intuition.

Assuming that the theory had been used to derive a set of empirically refutable hypotheses, scientific method would then have one examine a randomly selected set of rulings to test for conformity to the theoretical predictions. But the set of doctrines Landes and Posner examine is neither the full universe nor a random sample, but a carefully selected subset. So even if their inference is correct that each of the rules they examine is individually efficient, this mode of analysis cannot support the broader claim for the efficiency of the common-law process in general.

To be fair, Landes and Posner readily acknowledge that there may be many individual rulings that violate efficiency, and they list several specific examples that they so far find hard to rationalize. Of course, the force of my objections diminishes in direct proportion to the extent of their claims. If they are merely claiming that *some* decisions or rules have *some* prima facie rationality grounded in incentives for injury prevention, that is irrefutable, noncontroversial, and much less interesting. Surely they are claiming much more, if theirs is to be called the economic theory of common law. The implicit claim is that the dominant thrust of the law—however measured—is efficient. But in that case, how much deviation is tolerable before the underlying hypothesis of efficiency is to be rejected? How do we distinguish between the hypothesis that the common law is basically efficient, with minor aberrations, and the alternative hypothesis that it is basically inefficient, with minor pockets of efficiency? Thus unless their claim for the efficiency of common law is quite general, it is not falsifiable and is therefore empty. But if their claim is more general, then their methodology does not sustain it. The issue has a dy-

namic as well as a static dimension. Let us grant for the sake of argument that there is an evolution over time of the common law toward efficiency. How much delay is acceptable before we return a verdict of inefficiency and at least consider the alternatives of contractual freedom or statutory intervention?

The basic problem extends beyond this particular paper by Landes and Posner. Quite simply, we have today no quantifiable benchmark of a "workably efficient" common-law set of rules. Yet without this measure we have no way of arbitrating between the competing claims of Landes and Posner that product liability is efficient and of others among us who are more skeptical. Of course, this point is on the one hand quite fundamental and on the other hand rather picky, unless I have some such measure to propose, which I do not. So the rest of my comments will proceed on their terms, offering admittedly nonrigorous, qualitative arguments and empirical observations against some of their conclusions, without offering a clear cut refutation.

First, let me test the generalizability of some of their arguments. Landes and Posner rationalize the demise of privity in the past on the grounds that "advances in scientific knowledge have made it easier to ascertain the point in the chain of distribution at which a product . . . became defective."[2] But that reasoning should be reversible. It should argue for the *restitution* of privity for toxic chemicals with long latent side effects, such as asbestos, where it is very difficult to assign responsibility among numerous contributing parties. Instead, producer liability continues to expand, regardless of potential inefficiencies from erroneous attribution of cause, inefficient distribution of risk, or staggering transaction costs. The results in the toxics area thus seem to contradict a general testable implication of the Landes and Posner hypothesis.

II. The Costs of Information

The cornerstone of their defense of strict liability, against the prima facie more efficient alternative of contractual freedom, is the cost of information about product hazards to consumers. The argument is not so much inability to process information about low probability events as lack of incentive. For example, "[i]t is out of the question that [the consumer] should minutely inspect each soda bottle on the one in a million chance that it contains mouse parts."[3]

But it is not so obvious that the costs of obtaining information so clearly

[2] *Id.* at 549.

[3] *Id.* at 555.

outweigh the benefits. For risks that are reasonably uniform for all consumers, as in the mouse parts or exploding cigars examples, the manufacturer or some consumer surrogate such as *Consumer Reports* could presumably reduce to trivial levels the costs of *obtaining* information about the probability of injury, simply by publishing warnings. The issue is then the incentive to read and assimilate such warnings. But this depends not only on the probability of an injury for a single bottle of coke, but on the total expected value of the information. Let us allow that the odds of an explosion are one in a million, that the damages if an injury occurs are (conservatively) $1 million, that the average coke consumer drinks one bottle daily, and that technology changes each year, such that information becomes obsolete after a year. With these parameters, the value of information (ignoring discounting) is $365, which is surely sufficient to outweigh the time costs required to read the warning on a coke bottle once. Thus for many common consumer products, repeat purchase undermines the argument that it is not rational for consumers to process information about low-probability events. A similar logic applies in the case of consumer durables, which are frequently *used* although less frequently purchased.

The argument applies a fortiori in the case of producer goods, where the employer is often not only a repeat purchaser but also a large-volume user. The Landes-Posner logic would thus seem to support a negligence rule or upholding of contractual disclaimers at least for producer goods. A large number of product liability claims are employer claims for indemnification for workers' compensation losses. It is widely—and to me plausibly—alleged that this indemnification of employers through product liability, regardless of employer negligence, undermines employer incentives for injury prevention when their precautionary measures may be essential for the efficient production of care. Thus the case against contractual disclaimers, in favor of strict liability in tort, seems particularly uncompelling in the quantitatively important context of producer goods.

But returning to consumer goods, even if the argument that consumers lack incentives to process information were convincing in principle, it is belied by the evidence George Priest has assembled on the detailed content of product warranties.[4] He shows that the structure of product warranty clauses is quite consistent with the hypothesis that warranties are designed to encourage efficient investment in care, and is inconsistent

[4] George L. Priest, A Theory of the Consumer Product Warranty, 90 Yale L. J. 1297 (1981).

with the alternative hypothesis that warranties represent manufacturer exploitation of consumer ignorance. So this evidence from warranties seems squarely in conflict with the Landes-Posner argument that consumers will not choose to become informed about product risks.

III. The Definition of Efficiency

The formal model defines efficiency solely in terms of minimizing the costs of injuries and of injury prevention. Consumers and producers are assumed to be risk neutral. Courts are presumed to define the due care standards with perfect and perfectly known accuracy. The only information costs recognized are those of consumers in assessing injury risk. Of course simplification is necessary to build models, but the price here is too high, for Landes and Posner's model is no longer able to explain the relevant evidence.

First, the assumption of perfect information and hence perfect adjudication by the courts is clearly false. The unpredictable nature of tort rules and decisions, with random and perhaps systematic deviations from efficient due care standards, is obviously a major source of dissatisfaction with the current tort system.

There is an accumulating body of literature showing how variability in court decisions undermines the potential efficiency of the tort system as a signal for deterrence. It leads to an extensive demand for insurance even under a negligence rule, where in theory no such demand for insurance should exist. Because insurers cannot costlessly monitor care, such insurance is not fully experience rated, as is required for the appropriate transmission of incentives.

Second, the assumption of risk neutrality is clearly refuted by the demand for insurance. The risk neutrality assumption would be sustainable, if liability and first party insurance were universally available at actuarially fair prices. Then all parties would be fully insured and, at the margin, would be risk neutral. That is far from the case. For liability insurance, the loading charge is anywhere between 30 percent and 100 percent, depending on how one defines the benefits received. Part of this cost stems from the volatility of legal rules, which, as I have argued elsewhere, create nondiversifiable risk.[5] In the case of first-party health and disability insurance, the widespread provision through employment-based group programs, written on a year-at-a-time basis, is adequate for most acute problems, but seriously inadequate for the victim of a disabling injury

[5] Patricia M. Danzon, Tort Reform and the Role of Government in Private Insurance Markets, 13 J. Legal Stud. 3 (1984).

who becomes identifiable as a high risk and hence unemployable and uninsurable. With this institutional framework, risk and the bearing of risk entail costs that are too large to be ignored.

Because it omits risk, the Landes-Posner analysis is insufficient for making normative statements about efficient liability rules. And to the extent their model ignores a factor that the courts have apparently taken seriously, their model loses its predictive power. It seems clear that allocation of risk has been a major factor in the evolution of product liability law. It is also clear that concern over the cost of liability insurance is a major factor driving the demand for tort reform, both in medical malpractice and in product liability. It can be argued that the costs of insurance are currently unnecessarily high because the courts have, misguidedly, used the tort system as a vehicle for social insurance.

Finally, I would like to comment on their interesting empirical finding that the early abandonment of the privity doctrine is significantly correlated with the degree of urbanization in a state. They interpret this result as evidence that the shift to manufacturer liability is an efficient response to the growing complexity of products and relative disadvantage of consumers in taking care. Thus urbanization is interpreted as a measure of product complexity. In my analysis of the determinants of the frequency and severity of medical malpractice claims, I found that urbanization was the single most powerful predictor of both frequency and severity, after controlling for other obvious characteristics of urban areas, such as density of physicians and lawyers per capita.[6] Together these pieces of evidence suggest that urban courts have consistently led the movement toward expanded protection of consumers. Whether this is so because the costs of care are higher to urban consumers—the Landes-Posner hypothesis—or because of self-selection of "liberal" people to urban areas, or because urban consumers have greater need of market insurance, as family ties tend to break down in urban areas, or for any other reason, is an interesting topic that requires further research.

[6] Patricia Danzon, The Frequency and Severity of Medical Malpractice Claims, 27 J. Law & Econ. 115 (1984).