Subrogation and Insurance, With Especial Reference to the Tobacco Litigation

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

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

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

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

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

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

The scope of these arrangements is, moreover, not limited to reimbursement after the tort recovery is obtained. Equally important are decisions that determine the pattern of behavior prior to any tort recovery. Does the injured individual or first-party insurer control the suit? Do they split authority, and if so how? Who gets what kind of priority over the recovered money? Recall that the ordinary tort suit involves pain and suffering, which is normally not compensable by first-party insurance. It also involves lost earnings which may be offset by disability insurance. And finally, it covers the medical expenses, which are typically the object of health insurance. Generally speaking there is no case for having the first-party insurer recover for pain and suffering, which it did not bear. But on the other hand, two items dividing the proceeds is more difficult. Sorting out the nature of the recovery is a hard task to do in the abstract.

It seems that the right approach to this knotty problem is to let the two parties—the subrogee, as it is sometimes called, and the victim—work out between themselves a particular agreement that deals with each and every portion of the tort recovery. And just that is done in many cases.

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

Once a case goes into litigation, however, one's view of the merits and the justness and, I dare say, the "fairness" of the subrogation rules starts to differ, as Mr. Scruggs's presentation makes all too evident. Injured parties have peeked around the veil of ignorance, and they now endorse state intervention on noncontractual principles to upset the subrogation arrangement. These meddlesome activities are often disguised as "equitable" remedies that allow persons who enter into contracts on one kind of arrangement to repudiate that deal, and to keep the money that they promised to pay over at the inception of the arrangement. It amounts to treating a contractual obligation as an option not to honor the insurance contract.
I have been involved as a lawyer consultant for subrogees in the breast implant cases. The entire episode was highly instructive because it casts traditional plaintiffs into the role of defendants. Their attitude is that they do not have to worry about obligations under subrogation contracts. They are simply annoyances. The subrogees should not be allowed to enforce their rights as parties to the underlying litigation. The cooperation obligations of the first-party insureds do not count. Disclosures need not be made to prospective plaintiffs that their recoveries may be subject to subrogation obligations. Massive resistance was in fact the order of the day. How unfortunate! In a world which generates enough contention under the tort system—as it exists in terms of controversies between strangers—the only sound principle that one can deal with in these cases, when looking at the plaintiff’s side, is to allow the initial agreement to control, both with respect to the control of the litigation and the distribution of the proceeds, whether the money comes through litigation or settlement.

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

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

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

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

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

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

But it will then be said that Medicare and Medicaid are different because federal obligations mandate that states expend their resources to counteract the harmful effects of smoking. So states are not mere volunteers after all. Rather they are acting under some external obligation. But again the argument misses the point. The obligation in this case is imposed by a third party, the United States government. As
such, it takes the form of another unfunded mandate. Surely the right
answer is for the states and the federal government to work their
disagreements out between themselves. It is not to export them onto tort
defendants. The remedy for the state is to insist that federal revenues be
used to fund the discharge of state obligations. It creates far too much
risk of collusive behavior between state and federal government to allow
the federal compulsion of state action to create remedies against individual
defendants that would otherwise not exist. That rule would be regarded
as virtually self-evident in contexts apart from tobacco. It seems as
though it should be regarded as self-evident in this context as well. If $A$
and $B$ by contract cannot impose obligations on $C$, then $A$ by command to
$B$ cannot unilaterally impose obligations on $C$ either.

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

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

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

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

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

And I thought that tort litigation was approaching some level of parity, fairness, and balanced playing fields. But what some now want to do is redefine the playing field so that somebody who comes in, technically, as an assignee, now has an independent claim. What the government is constitutionally able to do on this world-view is pass legislation that says the tobacco companies owe it X billion dollars. That
is basically what is happening. Years ago, when I wrote *Takings*, ² I claimed that anytime liability rules are modified, anytime land use regulations are imposed, anytime new taxation is imposed, there has been a taking, and the issue that remains to be settled is either that of state-justification or state-compensation. Little did I know how true that was until I heard the proposals Mr. Scruggs now advocates. What makes it worse, in constitutional terms, is that the state is an interested party, and the state is preparing legislation that will grease the skids to its greater success. So what really makes me absolutely irate is the thought that somehow, the way that the public can win this dispute is for interested citizens to vote in a legislature that they conveniently control a claim to the cash that they wish to have.

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