

Law, Economics &

CIVIL JUSTICE

A Reform Agenda for the '90s

Edited by

Patrick B. McGuigan

with

Jeffery D. Troutt & Julia Chlopecki

and a foreword by

Dan Quayle



Free Congress Foundation

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Law, economics and civil justice

ALEX KOZINSKI

The crisis in our civil justice system is a crisis of self-interest. It is, to be exact, a *failure* of self-interest.

This may sound a bit strange. Many critics of the current system think that self-interest — or at least selfishness and greed — got us into this mess. When these critics go after the bad guys who caused the crisis, they round up the usual suspects — the tort victim with a sprained ankle and a million dollar emotional distress claim, or the unscrupulous businessman who conveniently discovers that a contract is “ambiguous.”

But these opportunists are only the beneficiaries — the fellow travellers — of the tort crisis; we must look elsewhere to find the real culprits. A more thorough investigation would put two names on the civil justice system’s Most Dangerous list. The first is the hardest to fight, as he has sincere, though misplaced, good conscience on his side. I’ll call this troublemaker the Misguided Altruist.

The second may think he’s serving his own interests, but actually lacks any understanding of where his self-interest lies. He’s the Expedient Myopic.

The misguided altruist

The Misguided Altruist believes that it is in the public’s best interest to expand the scope of the justice system. We’ve all heard some of the reasons supporting this theory: the justice system should play a part in redistributing wealth from the richest to poorest segments of society; courts should effect social change by enlarging and enforcing the rights of the powerless; structural social inequalities can be cured only through judicial takeovers of prisons, schools and even cities.¹ The Misguided Altruist truly wants to help the public; indeed, the implementation of his theories rarely benefits him in any direct way.

It should come as no surprise that the Misguided Altruist is most often found in the groves of the academe or in a judge’s chambers. While the academic variety of the species expounds the theoretical bases of misguided altruism, the judicial variety indulges in altruism in a more immediate and personal manner.

I am not suggesting that most judges are self-proclaimed judicial activists; in my experience, relatively few judges consciously try to implement a social agenda

in the guise of judging.² Rather, I think judges write their most expansive opinions when swayed by an individual litigant or a situation that evokes their compassion, exemplifying the axiom that hard cases make bad law. When confronting a case where the facts evoke compassion, a judge may be sorely tempted to turn bright line rules into balancing tests or do equity rather than obey the clear command of the law.

Such well-meaning meddling has had a dramatic impact on the judicial system. When a judge blinks at the words of a contract, or allows the equities of a situation to blot out the words of a statute, he sends a message to attorneys that everything is litigable. Though the result may seem just in the case before the court, the net result is a vast increase in the amount of litigation and, particularly, in the number of frivolous cases.

A good example of compassion run amok can be found in the saga of the implied covenant of good faith and fair dealing. It is easy to understand why the covenant first emerged: a judge wanted to avoid a harsh result and so decided to read the Golden Rule into every contract. The trouble began in earnest when judges decided that breach of this fictive covenant was a tort, making a party who violated this non-existent contract term liable for huge punitive damages.³

This golden carrot has significantly encouraged litigation. At present, a large portion of my calendar has been given over to reading between the lines of employment, insurance and loan contracts to determine whether the covenant that isn't there has been breached.

As the California Supreme Court recently noted in the employment context, under the current regime, "virtually any firing (indeed any breach of a contract term in any context) could provide the basis for a pleading alleging the discharge was in bad faith."⁴ This case, *Foley v. Interactive Data Corporation*, put a partial brake on the covenant's wild ride by holding that tort damages are not available for breach of the implied covenant in employment contracts. *Foley* is a good first step toward cutting back on litigation over employment contracts, but far from undoing all of the damage that Misguided Altruism has wrought.

Even worse from a jurisprudential perspective, as the invisible covenant looms larger in importance, it tends to swallow the actual words of the contract. Courts feel free to substitute their own notions of good proper business decorum for the words of the contract.⁵ In one case, plaintiff sued defendant for erasing videotapes of the "Winchell-Mahoney Time" television show. Defendant pointed out that the contract between them explicitly gave it the right to erase the tapes. This technicality did not trouble the court: It construed the erasure clause in light of the implied covenant of good faith and fair dealing, and ruled that defendant could be held liable for bad faith erasure. A jury ultimately imposed \$14 million in punitive damages on defendant for doing something the contract expressly permitted!

Decisions that encourage litigation are not only bad for the judicial system, they ultimately penalize everyone. A financial penalty is most immediately apparent. One study of the costs of the civil justice system revealed that in 1980, state and federal taxpayers paid more than \$2 billion for court expenditures.⁶

Although we cannot measure the hidden costs to individuals, we can safely predict that transaction costs will increase dramatically if people cannot rely on contracts or statutes. Anyone with any savings or wealth in the form of property must be prepared to defend it against a lawsuit based on some new or expanded theory of tort liability.

There is also a loss of personal freedom. Allowing courts to rewrite every contract deprives individuals of the power to structure their own agreements. A case I encountered a few years back presents a good example of this problem. In *Trident Center v. Connecticut General Life Insurance Company* (1988),⁷ an insurance company and two of Los Angeles' more prestigious law firms — sophisticated parties by any measure — were bickering over the terms of a loan agreement. That document, drafted by experienced attorneys, unambiguously precluded prepayment of the loan during the first 12 years. Nevertheless, the plaintiff argued that it was entitled to prove that the contract meant precisely the opposite. Amazingly, plaintiff was right; under California law, there is no such thing as an ironclad contract. As we explained,

it matters not how clearly a contract is written, nor how completely it is integrated, nor how carefully it is negotiated, nor how squarely it addresses the issue before the court: the contract cannot be rendered impervious to attack by parol evidence. If one side is willing to claim that the parties intended one thing but the agreement provides for another, the court must consider extrinsic evidence of possible ambiguity. If that evidence raises the specter of ambiguity where there was none before, the contract language is displaced and the intention of the parties must be divined from self-serving testimony offered by partisan witnesses whose recollection is hazy from passage of time and colored by their conflicting interests.⁸

Finally, decisions that prevent individuals from relying on the plain language of a contract or statute shift power to the courts. When there is always a chance that a judge may interpret contract or statutory language in some idiosyncratic way,⁹ parties can no longer guide their behavior by their own understanding. Courts, not the parties to the contract, will decide what bargain is fair; courts, not legislators, will decide what the law should be. The Misguided Altruist transforms the self-reliant individual into the eternal litigant. Rarely has altruism failed so miserably.

The expedient myopic

While we can view the well-meaning, albeit naive, Misguided Altruist with some sympathy, it's hard to have anything but scorn for the other mischief-maker in the civil justice crisis, the Expedient Myopic. This character, usually a lawyer or a corporate executive, cannot see past the rewards of the moment. In urging courts to push the law to its limits, he is no more acting in self-interest than is a gangster who tries to get rid of a rival by promoting tougher law enforcement.

I really can't blame the garden-variety plaintiffs' lawyer for adopting a short-sighted strategy. Nowadays, lawyers may even be liable for malpractice if they fail to argue that the pertinent language of contracts, statutes and case law does not really mean what it says, or if they fail to invent increasingly farfetched theories of liability — such as negligent impairment of psychic powers — which barely

pass the straight-face test. These attorneys will only curb their excesses if the law changes, altering their understanding of what is in their and their clients' self-interest. Limits on the availability and size of attorney's fees or punitive damages, and more vigorous impositions of sanctions for frivolous suits should go a long way towards altering the incentives of plaintiffs and their lawyers.

However, a greater responsibility must be borne by the lawyers who usually counsel deep-pocket defendants like insurance companies and major corporations. These lawyers are the ones who complain the loudest about decisions extending liability. Yet, over and over, I see them adopt the strategy of short-sighted plaintiffs' attorneys as soon as they become plaintiffs themselves. Instead of considering their long-term self-interest, they demonstrate their myopia by shooting themselves in both feet.

In my experience, insurance companies are the litigants most willing to lose the war in order to win a case. In *Morta v. Korea Insurance Corporation* (1988)¹⁰, for example, Morta's insurance company FHP, paid Morta's hospital expenses for injuries resulting from a car accident. FHP then turned around and sued KIC, which had insured the tortfeasor. There was only one catch: Morta had already settled his claim against KIC for \$900, and signed a form releasing the insurance company from liability for all claims, known or unknown. Undeterred, FHP argued that the release was not binding as to injuries unknown and unforeseen at the time it was executed. While we rejected this claim, it was not without wondering why FHP, an insurance company, was arguing for a rule that would undermine the validity of every release it had obtained — or would obtain — from settling other cases.

An equally disastrous strategy was pursued by an insurance company in *Carman Tool & Abrasives, Inc. v. Evergreen Lines* (1989).¹¹ That case involved a provision of the Carriage of Goods by Sea Act (COGSA), a mundane but important statute that limits a carrier's liability for loss or damage to \$500 per package unless the shipper declares the value of the goods on the bill of lading and pays a proportionally higher shipping rate. In an expansive reading of the statute, earlier Ninth Circuit cases required the carrier to give the shipper a fair opportunity to opt for higher liability.

In *Carman Tool*, the shipper's insurance company argued for an even more expansive reading. It seems that the shipper had decided to insure its goods with its own insurance company instead of paying a higher freight rate. When the goods were damaged in transit, the insurance company paid off — then turned around and sued the carrier.

The insurance company argued that the carrier was required to notify not only the shipper, but also the consignee of the goods, of the liability limit. The consignee was over 7,000 miles away and (as everyone understood) this requirement would place an impossible burden on the carrier. In effect, this rule would shift insurance costs to the carrier, who then, presumably would pass them on to the shipper. The end result: shippers would no longer be free to select a lower freight rate and insure goods with their own insurer. Instead, they would be required to accept the forced insurance of the carrier, hardly in the best interest of the

shipper's insurance company. Again, expedience and myopia triumphed over common sense and the insurance company's long-term self-interest.

No discussion of the Expedient Myopic would be complete without at least a passing reference to legislators. We know that myopia is built into the system: legislators are encouraged to think in two- or four- or six-year bites, and rarely have the energy to exercise any long-range vision. While this periodic accountability encourages legislators to keep the public's interest firmly in mind, it may also have less beneficial effects. Though legislators are well known for passing laws which offer quick-fix solutions, the public may be less aware that legislators often try to shift the burden of making unpopular decisions by purposely drafting ambiguous statutes. The myopic legislator assumes — usually correctly — that if the public can't figure out what a statute means, he won't lose any votes for having drafted, supported or voted for it. As I have previously noted,¹² this short-sighted policy has troubling effects.

As any judge or lawyer knows, ambiguous statutes both encourage and require litigation. After interpreting too many laws of this sort, judges may get into the habit of giving an interpretive spin to all statutes, not just to those which are vague and contradictory; power is shifted away from the legislature to judges who are generally not accountable to the public. Thus, while ambiguous drafting may be in the myopic legislator's short-term self-interest, it ultimately deprives him of the authority for which he sought office — and deprives the public of accountable leadership.

Taken together, the changes promulgated by the Misguided Altruist and the Expedient Myopic have three general effects: they enlarge the realm of the litigable; they encourage litigation; and they cede legislative power to the courts. None of these outcomes are desirable. Instead of ushering in an era of greater social justice, these changes have transformed our civil justice system into a devouring monster from whom no one is safe. The vast expansion of liability has resulted in increased costs of insurance, products and services, and increased delays in the administration of justice. As satirized in the well known cartoon of two litigants pulling at a cow while the lawyers get away with the milk, the monetary rewards of the system have frequently gone to attorneys, rather than to the poor and powerless. The shift of legislative power to the courts has eroded the public's right to have legislation enacted by its elected officials.

How can we counteract the thrashing these two miscreants have given our civil justice system? I suggest a vital first step: we must debunk the myths perpetuated by the Altruist by vividly showing to lawyers, judges, legislators and the public that an expansion of liability is ultimately in no one's best interest.

Then we must offer a new story, one showing that our true self-interest is best protected by a system that promotes clarity and certainty and that returns the job of making the laws to our elected representatives. This volume takes an important step in that direction.

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¹See, e.g., Edward Brunet, “Measuring the Costs of Civil Justice,” 83 *Michigan Law Review* 916, 934 (1985).

²However, even a handful of such activists can have a profound effect in expanding the scope of litigation, as did the few California judges who virtually invented product liability. See generally, Peter Huber’s excellent essay, Chapter 2 in this book. See also his brilliant and seminal *Liability: The Legal Revolution and Its Consequences*, (New York: Basic Books, 1988), pp. 5–10.

³Ironically, punitive damages are unavailable for breach of those terms that actually appear in the contract.

⁴*Foley v. Interactive Data Corporation*, 47 Cal. 3^d 654, 765 P.2^d 373, 254 Cal. Rptr. 211 (1988).

⁵See, e.g., *April Enterprises, Inc. v. KTTV*, 147 Cal. App. 3^d 805, 195 Cal. Rptr. 421 (1983).

⁶James S. Kakalik & Randy L. Ross, *Costs of the Civil Justice System: Court Expenditures for Various Types of Civil Cases* (Santa Monica, California: Rand Corporation, Institute for Civil Justice, 1983), p. 82. Unfortunately, I have found no study updating this excellent analysis of court expenditures nationwide. However, as filings continue to rise over the past nine years, costs must inevitably rise as well. One study shows that between 1978 and 1984 civil filings increased 88 percent in the federal courts. Galanter, “Beyond the Litigation Panic,” in Walter Olson, ed., *New Directions in Liability Law*, (New York: Academy of Political Science, in conjunction with the Manhattan Institute for Public Policy Research, 1988), pp. 20–21.

⁷*Trident Center v. Connecticut General Life Insurance Company* 847 F.2^d 564 (9th Cir 1988).

⁸847 F.2^d at 569.

⁹See, e.g., *Allstate Ins. Co. v. Pacheco*, 851 F. 2^d 257 (9th Cir 1988) (interpreting the term “motorized land vehicle” in an insurance contract as not including mopeds).

¹⁰*Morta v. Korea Insurance Corporation*, 840 F.2^d 1452 (9th Cir 1988).

¹¹*Carman Tool & Abrasives, Inc. v. Evergreen Lines*, 871 F. 2^d 897 (9th Cir 1989). The Carriage of Goods by Sea Act (COGSA) has been the subject of relentless and successful attacks in litigation largely funded by insurance companies. See generally, Sturley, “The Fair Opportunity Requirement Under COGSA Section 4(5): A Case Study in the Misinterpretation of the Carriage of Goods at Sea Act,” 19 *Journal of Maritime Law & Commerce* 1 (Part I) and 157 (Part II) (1988).

¹²See, e.g., Alex Kozinski, “‘True’ Meaning Subverts Justice,” *Wall Street Journal*, January 31, 1989, p. A14.