Reply to "The Effects of 'Early Offers' in Medical Malpractice Cases: Evidence from Texas"

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This article is a reply to the critique by Black, Hyman, and Silver (BHS) of our 2007 *Journal of Legal Studies* article, "An Empirical Assessment of Early Offer Reform for Medical Malpractice." The early offer reform gives insurers the option of making an early offer that will expedite payment of claimants' economic losses and reasonable attorney fees. Using data on closed medical malpractice claims from the Texas Department of Insurance (TDI), our 2007 article estimates the financial impact of this proposal by comparing the expected payments to claimants under the early offer reform to the payments tinder current tort rules. A central component of our calculation of expected payments is unique information on insurers' reserves associated with the claim; actual payments are reported in the TDI data for all litigated and settled cases involving payments of at least $10,000. The BHS article misrepresents fundamental aspects of our empirical analysis, including the following. BHS set out to correct our purported "false assumption" that all claims have a 1.0 probability of success, which is a problem that arises because BHS omit the probability of claimant success from the formula that is presented in our paper. BHS's error is compounded as their discussion of our paper fails to recognize that our use of reserve amounts in the analysis incorporates the insurers' estimates of the likelihood of claimant success, Indeed, they neither acknowledge our use of the insurer reserve data, nor do they use the insurer reserve information in their paper. BHS claim incorrectly that our analysis does not discount deferred payments whereas in fact it does. Our early offer analysis uses data for both litigated and settled claims, avoiding the selection bias and measurement error problems associated with BHS's extrapolation from the 2 percent of paid claims that are litigated to the universe of all settled and litigated claims. The BHS article also reflects a misunderstanding of the operation of the early offer reform.

I. THE EARLY OFFER REFORM PROPOSAL

The paper "An Empirical Assessment of Early Offer Reform for Medical Malpractice" by Hersch, O'Connell, and Viscusi (hereafter, HOV) develops a theoretical framework for estimating the financial implications of an "early offer" mechanism for resolving medical malpractice claims and presents empirical evidence using data on closed individual medical malpractice claims reported to the Texas Department of Insurance (TDI) in the time

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period 1988–2002.[1] The paper by Professors Black, Hyman, and Silver (hereafter, BHS)[2] also uses the TDI data and offers a critique of our analysis in which they purport to provide correct estimates of the financial implications of an early offer proposal for medical malpractice reform. However, their critique reflects a misunderstanding of the early offer proposal as well as a basic misunderstanding and a misrepresentation of our empirical analysis. We appreciate this opportunity to set the record straight.

We begin by reviewing the early offer reform proposal. Under the early offer reform, the defendant has the option of making a prompt early offer to settle the case within 180 days after the claim is filed for the value of economic damages and reasonable legal fees. The claimant is not required to accept the offer, but if the offer is refused the claimant would face a higher legal standard of proving gross negligence beyond a reasonable doubt. Thus, there would be the incentive for defendants to offer, and claimants to accept, prompt settlement of cases except for instances of egregious misconduct. The early offer plan would lower tort costs, reduce legal fees, and provide expedited coverage of claimants' economic losses. HOV provide an assessment of such financial consequences if the reform proposal were adopted.

Any sound critique of our assessment of the early offer proposal must first reflect an understanding of what that proposal entails. Unfortunately, BHS simply misunderstand a basic premise of the early offer reform. Notwithstanding the fact that the early offer plan is carefully and explicitly set forth in the sources they cite in their critique,[3] BHS repeatedly assume that defendants and claimants must agree on the value of the early offer.[4] This erroneous assumption leads them greatly astray.

Under the early offer program, the parties need not agree on the ultimate value of the early offer at the outset nor, indeed, at any point. Rather, the defendant calculates the expected value of an open-ended commitment to pay periodically a claimant's economic losses. If the insurer calculates an early offer amount that is less than its expected exposure under tort law, an early offer in all likelihood will be made. In effect, the defendant has the option of establishing a major medical/disability policy for the claimant in place of its common-law exposure. So just as there is no need for the insurer and the insured to agree at the outset of, nor at any point in, a major medical/disability policy as to the ultimate amount that may be paid out, there will be no such need in the case of an early offer. If the early offer is rejected, its purported value is irrelevant in the subsequent litigation.

The error of BHS with respect to the functioning of the early offer proposal also lures them into continually citing the tendency of an early offeror to "lowball" the early offer. The situation is analogous to that of a workers' compensation insurer, which also in effect issues

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[1] Joni Hersch, Jeffrey O'Connell & W. Kip Viscusi, An Empirical Assessment of Early Offer Reform for Medical Malpractice, 36 J. Legal Stud. S231 (2007).

[2] Bernard Black, David A. Hyman & Charles Silver, The Effects of "Early Offers" in Medical Malpractice Cases: Evidence from Texas, 6 J. Empirical Legal Stud. 723 (2009) <http://www3.interscience.wiley.com/cgi-bin/fulltext/ 123214961/PDFSTART>.

[3] Id. at 759–60.

[4] Id. at 731, 755.

a major medical/disability policy on an injured worker. Once such a policy is issued, by its very nature there cannot be a lowball commitment to pay workers' compensation benefits. Of course, as in any long-term health or disability policy, as payments become due, a difference may arise as to whether any given payment is justified based on a dispute as to the claimant's continuing need for medical treatment or wage replacement. But that is very different from the parties having to agree at the outset or later on the ultimate overall value of the offer.

This misunderstanding of the early offer proposal also explains why BHS are in error in assuming there will be little reduction in transactions costs on either side under the early offer plan we appraised. The BHS approach of applying defense costs under the current tort regime, which they observe are "front-loaded" with expenses for experts, is not pertinent to the early offer regime, for which we anticipate that most analysis will be performed by insurers in house. On the claimant's side, it is very unrealistic to assume, as BHS do, that a case settled within 180 days after an early offer will entail pretty much the same legal fees as full-scale tort litigation, even if resulting in eventual settlement.

II. Empirical Analysis

In HOV, we calculate the financial implications of the early offer proposal as follows. Conceptually, the early offer amount depends principally on "the expected liability and litigation costs if the claim is not settled under the early offer approach."[5] We emphasize that the key concept is the *expected* liability and litigation costs. The central building block of our entire empirical analysis is our use of the insurer's reserve amounts as the measure of the expected liability and litigation costs. HOV present analyses based on the insurer's initial reserve amount and final reserve amount. Insurer reserve amounts reflect the insurer's assessed probability of paying the claim as well as the expected payment levels. To emphasize, the probability that the insurer will pay any specific claim and the expected payment are built into the insurer's reserve amounts.

BHS erroneously characterize our empirical analysis. The straw man model that they attribute to us is that the early offer amount will be dictated by the actual economic damages that are paid to the claimant, where we purportedly assume all claimants recoup payments with probability 1.0. Much of their article is then devoted to fixing what BHS claim is our purportedly "false assumption" that all plaintiffs have a 1.0 probability of success. After correcting our alleged error by introducing a probabilistic component into their straw man version of our model of the early offer system, much of the remainder of the BHS analysis is devoted to exploring how hypothetical probabilities of plaintiff success will alter the results for tried cases.[6]

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[5]As described in HOV, other components affecting the offer in the fully articulated version of the model include the portion of the defendant's litigation costs already incurred before making the early offer and the value of the claimant's economic damages. HOV, supra note 1, at S234.

[6]The equation in BHS, supra note 2, at 8, is not equivalent to our formula. First, the defendants under our system will use as their reference value the expected economic damages payout. Thus, their formula (id. at 11), which includes

However, BHS are completely wrong in asserting that we assume that plaintiffs have a 1.0 probability of success. Our use of the insurer's reserves incorporates both the probability of plaintiff success and the distribution of expected payout amounts. In statistical terms, for a simple binary outcome of paying or not paying damages, expected costs represent the product of the pertinent probability of claimant success and the dollar payment amount so that we never assume, as BHS claim, that there is no probabilistic component.

Indeed, we explain this expected value calculation on p. S239: "The maximum amount c that an insurer would be willing to offer to resolve a claim under the early offer reform is determined by the insurer's expected liability and litigation costs of proceeding with the claim under normal tort law. This expectation takes into account the probability of settling the claim or losing the case at trial. These probabilities are incorporated in the reserve amounts, which are our first two measures of c." Notably, not only do BHS ignore our inclusion of the probability of claimant success, but nowhere in their article do BHS make any reference whatsoever to our use of the insurer's initial reserve and final reserve amounts for assessing the expected value of the claim, which is the core of our empirical approach. Nor do they ever use the reserve information in the TDI data set. These reserve amounts incorporate the insurer's own assessment of the probabilities associated with different payoff amounts and represent a far superior approach to the BHS's approach of hypothesizing different plaintiff chances of success.[7]

We now turn to other methodological points.

HOV use the actual case-specific information for 16,437 cases with paid claims, including settled claims, over the 1988–2002 period. In contrast, the BHS paper focuses on a subset of 358 tried cases over the period 1988–2005, and the remainder of their article simply extrapolates from these cases to settled cases. For settled cases, BHS impute the economic and noneconomic damages shares based on tried cases, and they also make other assumptions about which early offers would be attractive for settled cases based on their results for tried cases. Their simplistic approach extrapolates from the 2 percent of the cases that are tried to the remaining 98 percent paid claims that are settled, where the case mix will differ given the selection of cases for litigation. Moreover, the terms of settlement and the settlement components for settled cases need not mirror tried cases. Thus, the main component of their critique has a severe data mismatch with our data. In focusing on tried cases, they use these cases to do a sensitivity analysis for the plaintiff's hypothetical probability of success. Their settled case analysis, in their words, is "to extrapolate from tried cases . . . ."[8]

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the probability of plaintiff success, is more germane to our approach and what we have done in our calculations. We reemphasize that an insurer's early reserve and final reserve cost estimates incorporate these probabilistic components. Second, our early offer formula for the value of an early offer to the defense nets out the litigation costs incurred by the defense before making the early offer. Their formulas on pages 8 and 11 ignore this term.

[7]BHS claim that they "lack data on the ex ante odds of plaintiff success for the tried cases in our data set, which plaintiffs in fact won, viewed ex post." BHS, supra note 1, at 735. However, such probabilities are incorporated in the insurer reserve amounts and need not be the subject of speculation.

[8]Id. at 739.

BHS impose a $25,000 claims payment minimum for cases to be included in their sample, whereas our sample includes claims above $10,000.[9] Their data go through 2005, which creates complications because of the impositions of the noneconomic damages cap in Texas in 2003. Our data period purposely ends in 2002. Thus, we were careful to appraise only the effects of early offers when caps on damages are not in effect. Indeed, in material cited by BHS, Jeffrey O'Connell has indicated how unfair caps are to the most seriously injured, pointing out that they also accrue to the advantage of all defendants regardless of how well or ill they treat claimants. Under the early offer proposal, defendants will have to earn the right to limit damages by offering to pay promptly only claimants' essential losses.[10] Thus if an early offer law were adopted, any caps might well be eliminated.

HOV discount deferred payments using a 3 percent real (i.e., inflation-adjusted) interest rate. Nevertheless, BHS claim incorrectly that we fail to take into account the role of discounting of deferred payments. They then offer their own present value calculations using an unrealistically high interest rate of 10 percent. While that is the statutory Texas rate for prejudgment and postjudgment interest, our article assesses an early offer proposal to be implemented nationally. An interest rate figure of 10 percent is not a realistic value for the current real opportunity cost of capital. Presumably, the Texas statutory values had other purposes to serve, such as inducing prompt payment. Rates as high as 10 percent are not appropriate for purposes of calculating the present value of economic loss in personal injury cases and are not used by government agencies. BHS's use of such an inflated interest rate overstates the influence of present value adjustments. Our 3 percent rate is a much more accurate measure of the real risk-free rate of interest.[11]

Let us now turn to the numbered summary of criticisms of HOV by BHS. We adopt their numbering of the same series of eight criticisms and provide our corresponding response.

1. *No minimum offer for all cases.*[12] Yes, that assumption is a feature of the proposal, though we do analyze the effect of minimum offers of $100,000, $250,000, and $500,000 for fatalities and serious injuries. The serious injury categories of amputations, brain injuries, and spinal cord injuries were designated "serious" because these were the cases with the largest amounts of noneconomic damages. To the extent that less serious injuries involve smaller economic losses, they will be compensated for their actual losses. But because they are less serious, the noneconomic losses that are not compensated will be less than they would be for serious injuries. It would certainly make no sense to adopt their minimum payment amount of $50,000 for our sample, for which the actual payment

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[9]Id. at 724, 728; HOV, supra note 1, at S242 n.18.

[10]Jeffrey O'Connell & Christopher Robinette, A Recipe for Balanced Tort Reform: Early Offers with Swift Settlements 96 (2008).

[11]HOV, supra note 1, at S251, S254.

[12]BHS, supra note 1, at 746.

minimum is $10,000. Their assumption of a minimum offer of $50,000 will lead to an understatement of the savings from the early offer proposal.

But BHS complain bitterly about the early offer proposal that uses the leverage of encouraging prompt payment of economic loss at the price of eliminating noneconomic coverage.[13] These critiques have nothing whatsoever to do with the accuracy of the empirical estimates in HOV, which is not an advocacy piece but is an unbiased empirical assessment. Rather, that BHS critique is largely an editorial commentary on the desirability of the early offer approach. The result of the early offer proposal, BHS assert, will be to disadvantage people whose economic losses from alleged medical malpractice are low.[14] Precisely. Scarce insurance dollars should go to pay for large dollar losses. As to their example of the wrongful death of a retiree with zero economic damages, the HOV analysis presents calculations in which serious injuries and wrongful death cases are subject to minimum offers of $100,000, $250,000, or $500,000. If the polity chooses not to incorporate such minimums as part of an early offer plan, then the economic losses incurred by claimants and their survivors nevertheless will always be fully addressed under the early offer proposal.

2. *Two-thirds of the damages are noneconomic.*[15] This statistic is not an assumption but is an empirical result. Moreover, their questioning of our approach suggests that they may have misunderstood the TDI data. The BHS discussion misrepresents what we did and, as indicated above, their focus on 358 tried cases and the use of the damages division in those cases ignores the characteristics of the 98 percent of the cases for which the early offer proposal could apply. Their critique is as follows: "HOV use the insurer allocation where it is provided. Where it is not, instead of accepting the insurer's allocation of 0 percent of the settlement to noneconomic damages, HOV rely on Florida data to impute percentages of noneconomic damages ranging from 64 percent to 85 percent, depending on the type of case and plaintiff demographics."[16] This statement is false. The breakdown into the damages components is available for 5,733 cases. Of these, 179 cases have zero economic damages.[17] These zero values were correctly treated by us as true zeros. For cases in which there was a positive payment amount but the insurer did

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[13]Id. at 756–57.

[14]Id.

[15]Id. at 747.

[16]Id. The BHS noneconomic damages share figure of 85 percent should be 84 percent. More generally, HOV, supra note 1, at S242, calculate the following economic damages shares by case type: "The economic damages shares of the total award are as follows: .359, nonfatal, under age 18; .156, nonfatal, age 18 and over; .345, fatal, under age 18, and .246, fatal, age 18 and over. Because age and injury type are not reported for TDI short form claims, we use the same economic share of .348 for all short form claims, which is calculated as the weighted average of the economic damages share for all nonfatal claims."

[17]HOV, supra note 1, at S241, S242, S246. The 179 figure has been calculated by HOV using the TDI data.

not report the breakdown of the damages components, the TDI recorded zeros for all the values that would otherwise contain the damages components. However, as the minimum payment for inclusion in the TDI sample is $10,000, it is impossible that all damages components are zero, as that would have led to a zero payment amount in these cases. For those cases for which the breakdown is not reported, we imputed the noneconomic damages amount using Florida data. These data are not restricted to trials, as is the BHS imputation of economic and noneconomic damages for the settled cases, but include all insurer payouts regardless of context, as does the TDI sample. Because the characteristics of tried cases are quite different from settled cases, the BHS procedure of using tried cases to impute the share of noneconomic damages for all settled cases is clearly fraught with error.[18] Note that for the 5,733 cases for which the damages breakdown is reported, HOV find that the noneconomic damages share of the total settlement or court award is 58 percent, and that excluding exemplary damages and prejudgment interest, it is 66 percent.[19] Notwithstanding BHS's general uneasiness regarding our use of the Florida data, the noneconomic damages shares are similar to those in the TDI data.[20] In contrast, BHS estimate that noneconomic damages are 40 percent of the tried case payout and 52 percent of their projected settled case payout extrapolated from their sample of tried cases. In contrast, HOV use actual data from settled cases.[21]

3. *Current payouts do not fully pay economic damages.*[22] This BHS claim is not relevant to our model. The HOV analysis using insurer reserves makes no use of jury award amounts. The initial reserve and final reserve analyses incorporate the insurer's expectation of whatever damages will be paid, which will fully account for expectations that jury awards may be reduced. Similarly, for our third set of calculations based on the actual settlement or court award, the TDI data reflect the actual amounts paid by insurers.

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[18]The failure by BHS to provide a separate analysis for settled cases has other ramifications as well. For example, they provide results assuming that an early offer is made only when estimated economic damages are less than $200,000, which they claim is the level below which early offers are attractive for tried cases. BHS, supra note 2, at 724, 725, 736, 737. However, our analysis is specific to each particular case, whether settled or not, and does not extrapolate from tried to settled cases. Their finding that their "results for settled cases are broadly similar to those for tried cases" is unsurprising given that their analysis of settled cases simply extrapolated the results from tried cases. Id. at 740.

[19]These calculations are based on data in Table 1 of HOV, supra note 1, at S243. It should be emphasized that prejudgment interest is interest paid on damages components. It is not a separate damages category that would be present if there were no other damages.

[20]BHS, supra note 2, at 747–48, expre skepticism regarding the use of the Florida data and indicate a failure to understand the use of the data. However, our calculations were quite straightforward and are described in HOV, supra note 1, at S242.

[21]BHS, supra note 2, at 725.

[22]Id. at 748.

4. *An assumed contingent fee of 9 percent of gross payout.*[23] This is a slightly misleading statement since it is actually 10 percent on top of the payout.[24] The 10 percent figure is an illustrative assumption. The base for calculating the fee is different than under the current system. It does not ignore market-clearing price information but rather incorporates the fact that the market will be different under this proposal, with transactions costs that will be much lower.

5. *Ignoring plaintiff's out-of-pocket expenses.*[25] The litigation costs that plaintiffs incur if there is no recovery under the early offer proposal are irrelevant since we view such plaintiffs as being part of the existing tort system. If there is an early offer payment, presumably the parties can negotiate such out-of-pocket expenses to come out of the 10 percent fee. The early offer proposal imposes no restrictions on claimants' ability to negotiate the reimbursement of expenses out of the 10 percent fee.

6. *Ignoring the time value of money.*[26] We do not ignore it. We account for the present value when calculating the value of litigation cost savings.[27] The BHS examples overstate the influence of time discounting for two reasons. First, to the extent that they focus only on tried cases for which the time delays will be greater, their analysis overstates the influence of discounting. (Their criticism Number 6 does not specify where their delay numbers come from.) Second, their interest rate of 10 percent as compared to our much more realistic rate of 3 percent greatly inflates the influence of discounting.

7. *Plaintiffs' chance of success will be less than 100 percent.*[28] The BHS discussion errs in several respects, which is an error attributable to their failure to use, as we do, the initial and final reserve information in the TDI data. We do not "effectively assume" that plaintiffs have a 100 percent chance of recovery in all cases, both settled and tried."[29] We did not assume that defendants now pay all economic damages or would pay these damages under the early offer proposal. To repeat, the insurer's reserves (whether initial or final) incorporate the defendant's assessed probability that the claimant will win the case and the expected amounts that will be paid. Thus, it is the expected payoff that is the key component of the analysis, both theoretically and empirically. We also present results regarding the actual insurer payment amount as an instructive measure based, as is the final reserve, on hindsight rather

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[23]Id.

[24]HOV, supra note 1, at S238.

[25]BHS, supra note 2, at 725, 746, 749.

[26]Id. at 749.

[27]HOV, supra note 1, at S251, S254.

[28]BHS, supra note 2, at 750.

[29]Id.

than foresight. Note that while not all plaintiffs' claims are paid in general, all claims in the TDI data were in fact paid. As our use of reserve amounts incorporates the insurer's perceived probability of plaintiff success, it would not have been appropriate to multiply the early reserve or final reserve amounts by the plaintiff's probability of success because that would, in effect, be multiplying the payoff amount twice by the probability of plaintiff success.

8. *Seventy percent drop in defense costs.*[30] This is simply the parallel assumption to the 10 percent versus 33 percent plaintiff cost shares.[31] It is not appropriate to use a regression analysis to extrapolate from current defense cost levels as BHS do, even for settled cases, because the early offer proposal provides a settlement structure and a mechanism that does not currently exist. The early offer reform will expedite the resolution of cases.

III. Evaluation of BHS's Alternative Early Offer Program

BHS complain that it is unfair that the early offer that triggers the law's operation can be made only by defendants.[32] So they propose an alternative dual system whereby either party—claimant or defendant—can impose a cost on the other for refusing to accept a given offer to settle.[33] But the early offer program we appraised will be viable only if defendants, not claimants, are allowed to make binding early offers. Claimants and their counsel lack sufficient incentives to weed out nonmeritorious claims if they have the power to unilaterally bind defendants in some way by their claims. But defendants, as the parties making payments, will appropriately make no early offer when confronted with clearly meritless or very marginal claims. Thus defendants have the right incentives to distinguish between arguably valid and clearly invalid claims such as to bind the other party by prompt payment of the required minimum benefits in suitable cases.[34]

As a way around this dilemma, BHS propose a two-sided early offer fee program under which plaintiffs could offer to settle for economic damages, plus an attorney fee percentage; defendants would then face a "stick" if they refuse a plaintiff's offer and the plaintiff (1) later wins at trial and (2) is awarded economic damages that equal or exceed its offer.[35] But, as seen, their own data, like ours, show that only a *very* small percentage of

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[30]Id.

[31]See supra notes 18–19 and accompanying text.

[32]BHS supra note 2, at 757.

[33]Id. at 757–58.

[34]O'Connell & Robinette, supra note 10, at 128.

[35]BHS, supra note 2, at 757–58.

cases result in trial.[36] So by that criterion, there will be very few instances where their test applies. It is, after all, the difficulty of predicting the ultimate verdict that encourages the parties to settle in an overwhelming percentage of cases. Thus the authors propose to add to the settlement process, already fraught with uncertainty, a hypothetical penalty based on a prediction of an unpredictable factor that leads to settlement in the first place. Also, how likely is it that one party agreeing to a settlement will agree to a further penalty for agreeing to that settlement?

Quite apart from this difficulty, the authors then go on to admit that payouts "would be likely to rise under [such] a two-sided program." They then note: "[W]e're not holding our breath waiting for it to be adopted."[37] BHS seem conscious of a lesson reformers (including those currently proposing changes in health insurance) often learn: a reformer who goes to the legislature promising to improve things but at a substantially higher cost often faces the response, "Who couldn't?" A key, then, is reform that will improve things at no greater or even lesser costs—which is the goal of the early offers plan we appraised.[38]

Finally, we note the penultimate phrases of their piece wherein BHS make a concession that we at least deserve some credit for offering empirical evidence, "however flawed," on the potential impact of an early offer plan.[39] Our supposedly errant efforts are praiseworthy, they assert: "Without empirical estimates, we are left with rhetoric" of which they assert society already has an ample supply "in the tort reform debate."[40] Then immediately, in the final phrases of their paper, they repeat (if anyone had missed it earlier) their own characterization of the early offer plan as a " 'kill granny cheap (or free)' tort reform."[41]

This from those who purport to decry rhetoric.

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[36]Id. at 729.

[37]Id. at 758.

[38]Note, too, that another reform proposal of BHS would require higher malpractice insurance limits, also at higher costs. Id. at 757.

[39]Id.

[40]Id.

[41]Id. at 756, 759.