Corporate Liability: How Big Is the Real Price Tag?

Why businesses worry about liability

In the last decade, the legal liabilities facing U.S. corporations have expanded substantially. Traditional liabilities such as those associated with defective products have become more stringent. In addition, new liabilities have emerged—most notably in the areas of hazardous waste disposal and wrongful termination. These changes in liability law have substantially increased the amount of litigation against business (see Dertouzos, Holland, and Ebener, 1988; and Dungworth, 1988).

The corporate sector, arguing that the nation is paying a high price for these new rights given to consumers, employees, and workers, claims that the new liabilities have significantly reduced both the productivity and the international competitiveness of U.S. firms.

Despite the vigor of these claims, however, there are no data to support them. The few studies that have examined the effects of expanded corporate liability have focused on “direct costs,” including insurance premiums, legal fees, and indemnity payments. The studies suggest that, in general, direct product liability costs represent less than one percent of value added in manufacturing. An ICJ study of wrongful termination in California estimated that this liability added an average of only $12.25 per employee to the annual costs of doing business.

But legal liabilities represent an important behavioral influence on corporations, which is only partly captured in indemnity and defense payments. In The Economic Consequences of Expanded Corporate Liability: An Exploratory Study, Peter Reuter presents a framework for analyzing how liability might have significant economic effects and offers some preliminary evidence that liability concerns do indeed influence corporate behavior.

Rethinking the problem

Reuter’s framework is based on the following assumption: The effects of legal change on economic performance can be traced only by analyzing how the changes affect the behavior of individual firms.
For example, expanded product liability may motivate firms to spend more on product safety testing or to screen products more carefully before marketing them. As a result, firms may introduce fewer unsafe products, but some safe products will fail to reach the market. In the same way, more stringent review of termination decisions means that some workers who should not be fired will be retained, but the new rules may also increase the number of workers retained who should have been fired.

These changes in firms' behavior may change firms' outcomes. For example, fewer new products may enter the market, firms may be slow to adjust their work forces, etc. It is through these shifts in outcomes that increased business liability may affect productivity and international competitiveness.

**Testing the framework**

To test this framework, Reuter conducted individual and group interviews with senior executives and legal counsels representing the chemical, pharmaceutical, and semiconductor industries, and a set of small businesses. The participants were asked how their firms had changed behavior in response to the expansion of particular liabilities. From their responses emerged the following conclusions:

1. Product, employment, and environmental liabilities have the broadest range of influences on corporate behavior.

2. These liabilities have influenced many dimensions of corporate behavior and a wide range of decisions—some of them seemingly unrelated. For example, concerns about environmental liabilities have influenced not just waste handling and disposal but site selection, corporate acquisitions, and choice of process as well.

3. Liability effects vary significantly across firms. For example, wrongful termination seems to be a more serious problem for semiconductor firms, which face very cyclical demand and employ a well-educated work force, than for pharmaceutical firms.

4. Liability interacts with other influences, such as regulation and market forces, and sometimes the effects are counterintuitive. For example, environmental liabilities seem to have little effect on the siting decisions of chemical firms because the firms are already constrained by the requirements for site permits. But environmental liabilities do figure prominently in decisions by semiconductor manufacturers because they have significant waste disposal problems.

**Taking the next step**

These findings indicate that to examine the economic consequences of expanded liability, we need to cast a wider net—look beyond direct costs to how business responds to real and perceived risks of liability. The insights derived from this exploratory study form the core of current ICJ efforts to establish a program of research designed to tell us what the real business liability price tag is.

The following ICJ publications are cited in this Research Brief:


The research summarized in this brief was carried out within the Institute for Civil Justice of The RAND Corporation. Research results are described in detail in N-2807-ICJ, *The Economic Consequences of Expanded Corporate Liability: An Exploratory Study*, by Peter Reuter, 54 pp., $7.50.

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