

## EFFICIENCY IMPLICATIONS OF THE SINDELL-REXALL RULE

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In 1980, California established the rule of market share liability in *Sindell v. Abbott Laboratories*.<sup>1</sup> This rule sets a firm's liability equal to its market share. Thus, if a firm has 50 percent of the market, it is liable for 50 percent of total damages. Recently, the U.S. Supreme Court refused to hear *Rexall Drug Co. v. Tigie*.<sup>2</sup> This case originated in New York and expands the *Sindell* rule of apportioning the level of a firm's liability in accordance to the firm's market share. *Rexall* expanded *Sindell* by holding Rexall liable for its market share of damages, even though Rexall had shown that its product could not have caused the damages. Although market-share liability has so far been applied only to the pharmaceutical industry, specifically in DES (diethylstilbestrol) suits, this paper considers the general implications of this rule for the provision of care.<sup>3</sup> In particular, the analysis focuses on the impact of altering the rule of products liability—from having a firm pay for its own damages to that of market-share liability.

The first section of the paper considers the division of damages under the classical theory of tort, while the second section examines the efficiency implications of the adoption of the Sindell-Rexall (S-R) rule. The paper reaches two conclusions: (1) The adoption of the Sindell-Rexall rule reduces a firm's perception of the marginal benefits from providing care and leads to a reduction in care. (2) Low-care provider's costs fall while high-care provider's costs rise, leading

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<sup>1</sup>26 Cal. 3d 588, 607 P. 2d 924 (1980).

<sup>2</sup>73 N.Y. 2d 487; 539 N.E. 2d 1069 (1989). See also Greenhouse (1989) and Wermiel (1989).

<sup>3</sup>Landes and Posner (1987, p. 212) briefly discuss market-share liability and DES cases.

to an expansion of output by the low-care firm and a contraction in output by the high-care firm.

### *Sindell* and the Abandonment of Causality

The classical theory of tort contains three elements of a legally persuasive tort.<sup>4</sup> These are a breach of duty by the defendant, existence of damages, and proximate causality of the damages by the defendant as a result of the breach of duty. Under the classical theory of tort, if the plaintiff cannot prove that the defendant was the proximate cause of damages, then recovery is denied. Thus, if one of a group of defendants is known to be the party whose product has caused the damages, but whose exact identity is unknown and unprovable, then the plaintiff would be denied recovery. The doctrine of market-share liability is an attempt to solve this problem by reducing the requirements of proving that a causal relationship exists between a single correct defendant and the plaintiff.

The original doctrine of market-share liability was developed by the California Supreme Court in *Sindell v. Abbott Laboratories* as a result of the failure of the evidence to identify a single defendant as the party who produced a defective product, in this case DES. Market-share liability involves awarding damages to the plaintiff in proportion to the defendant's share of the relevant market. For example, a firm with 40 percent of sales in the relevant market would be liable for 40 percent of the total damages to plaintiffs injured by the firm's product. Under *Sindell*, if a firm could prove that its product was not involved in the accident, then it would be excluded from the relevant market and not be held liable.

The pertinent question is how the firm responds to this reduction in causality. The most plausible response would be for firms that produce safer products to track the use of their products more effectively in an effort to escape the payment of damages generated by firms that provide lower levels of product safety. To the extent that firms are able to track their consumers, they may escape the effect of *Sindell*. Thus, even as a general rule, *Sindell* may not have generated an excessive change in the provision of product safety but only increased the firm's paperwork. *Rexall* expands *Sindell* by requiring firms to pay in proportion to their market share *even if* the firm can prove that its product was not the product involved in the damages. Consequently, *Rexall* completely abandons causality between the provision of risky products and liability for the damages generated by these products.

<sup>4</sup>This section relies on Cooter and Ulen (1987).

## The Efficiency Implications of the Sindell-Rexall Rule

In this section we consider the general implications of the adoption of the S-R rule for the apportionment of damages. First, consider the implications for a representative firm. Under a system in which the firm pays for the damages generated by the use of its products, these damages will be incorporated into the firm's cost of production. The firm will allocate resources to the reduction of damages as long as the marginal cost of doing so is less than or equal to the reduction in damages. The firm will be driven to provide product safety as long as doing so generates more reductions in damages than increases in costs. This process of cost minimization will result in the efficient level of care being provided by the firm.

The S-R rule affects the firm by altering its perception of the benefits from the provision of product safety. Under the S-R rule, a dollar's worth of expenditures on product safety will not lower the firm's liability for damages by a dollar. Rather, damages will be reduced by a fraction of a dollar, that is, by a dollar times the firm's market share. Thus, the S-R rule reduces the benefit to the firm from the provision of product safety. With the decrease in benefits, the firm will reduce its provision of product safety until it is providing that level of safety for which the benefits generated through the reduction in damages are, at the margin, equal to the cost of product safety.

Consider a firm that is providing care to the point where the cost of providing care is equal to the reduction in damages from providing care, and both are equal to \$1. Under the classical theory of tort, the firm would receive the entire benefit, \$1, from the reduction in damages. If this firm has a 40 percent market share, then under the S-R rule the provision of the last dollar's worth of product safety would yield benefits equal to \$.40. Since the firm is now spending \$1 to achieve a \$.40 reduction in costs, it will be in its interest to reduce the provision of product safety and reduce its cost by \$.60. Thus, the S-R rule has the effect of reducing the provision of product safety.

The adoption of market-share liability also affects the relative costs of firms that provide high and low levels of product safety. Consider a market where two equal-sized firms are producing a product, one with a high level of product safety and the other with a low level of product safety. Under the classical theory of tort, the firm that produces the safer product will pay lower damages. The S-R rule, on the other hand, requires each firm to pay damages equal to its market

share, which means each firm will pay 50 percent of the total damages. For example, if total damages were \$3,000, each firm would pay \$1,500; whereas under the classical theory of tort, the safer firm would benefit by paying say \$1,000, while the more careless firm would pay \$2,000. Thus, under the S-R rule, the high-safety firm experiences an increase in its cost while the low-safety firm experiences a decrease in its cost.

Under the classical theory of tort, a firm that provides a high degree of product safety will be absorbing damages that are less than the market average. The imposition of the S-R rule has the effect of forcing each firm to absorb damages as if its product were generating damages equal to the market average. This causes the costs of a high-safety firm to increase and leads to a reduction in its sales. Meanwhile, a low-safety firm will experience a fall in its costs as a result of the reduction in its share of total damages under the S-R rule. As a result, firms with low levels of product safety will find their sales increasing. Hence, the adoption of the S-R rule will expand the sales of low-safety providers and decrease the sales of high-safety providers.

Market structure has an obvious bearing on the firm's perception of damages under the S-R rule. If there is only one firm in the market, its market-share liability is unimportant because the firm absorbs all costs and benefits related to its product. At the other extreme, as the number of firms increases and market shares decrease, firms will have less incentive to take account of the damages they incur from unsafe products; thus, these firms can be expected to provide smaller amounts of product safety than firms in more concentrated industries. At the limit, the competitive firm's market share will be so small that its provision of product safety will have little or no impact on its payment of damages.

In the case of oligopolistic markets, a more interdependent model of the firm's behavior is needed to ascertain the impacts of market structure on the firm's perception of damages. But even in the presence of high levels of recognized firm interdependency, the effects of the adoption of the S-R rule would still be to reduce the perceived marginal benefits of the provision of product safety, to increase costs for high-safety firms, and to reduce costs for low-safety firms. Thus, with the exception of classical monopoly, market-share liability will reduce the provision of product safety, increase the risks of consumption, and result in larger damage claims.

## Conclusion

The establishment of market-share liability appears to serve neither the cause of economic efficiency nor that of minimizing the harm

to product users. It provides an incentive for all firms to shirk while reducing the costs of firms with low product safety. These two factors will reinforce each other and likely lead to an increase in damages. If the S-R rule is limited to those firms that deal with long-term latent risks of a chemical nature, such as DES and asbestos, its impact may well be restricted to the chemical and pharmaceutical industries. The more interesting questions are whether the S-R rule will be extended to other types of products and whether causality will be completely abandoned when determining liability. Either of these results will increase the risk of consumption and the damages that result.

The policy question is whether the single-minded pursuit of compensation, regardless of who is required to pay, is acceptable. Not only does the abandonment of causality raise serious equity questions, it also discourages the pursuit of product safety. Do the courts really expect a liability system that rewards low-safety firms—by reducing their costs of production—to provide safer products? It seems more likely that market-share liability will reduce product safety by all producers and increase the output of low product safety providers.

The rule of market-share liability also raises questions with respect to the efficiency of tort law. Indeed, the establishment and spread of a clearly inefficient rule does not portend well for those who contend that the tort system is efficient. However, this question is not settled. The result will depend on whether the market-share liability rule spreads to other areas. However, if the tort system is efficient, then the S-R rule will eventually be conscribed to the dust bin of history.

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