
The Growing Threat to Economic Development:

Wisconsin's Immediate and Critical Need for Legal Reform

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The **Wisconsin Economic Development Association (WEDA)** is a statewide non-profit organization of economic development professionals dedicated to expanding the economy of the State of Wisconsin.

Background

In 2005, the Wisconsin Supreme Court issued several decisions affecting Wisconsin's civil justice system which led to the *Wall Street Journal* labeling Wisconsin as "Alabama North" and which has caused many leaders in the economic development community to elevate "litigation atmosphere" (or "tort climate") to the top of the list of economic development issues facing the state. Legislative enactments in response to these cases, and other perceived shortcomings in Wisconsin's civil justice system, were mostly vetoed, leading the same economic development leaders to solidify the view that the new reputation for anti-business litigation atmosphere is the Number One economic development issue in the state.

The Wisconsin Economic Development Association (WEDA) has asked for an examination of the validity of this concern. The paper concludes that developments over the past two years have created a negative reputation for Wisconsin's tort climate. This is a very serious economic development problem and it is increasingly recognized. At least three national rankings in 2006 document this perception.

The paper is entitled: "The Growing Threat to Economic Development." Given the negative national publicity, the threat is growing rapidly. It is real, but to the general public and broad-based media, it does not have the same "sex appeal" as other high profile issues. The perception and the reality (clearly one and the same here) of the litigation atmosphere and current liability crisis are daily issues that face economic development professionals as well as businesses examining retention, expansion and location decisions.

The paper examines many of the issues broadly from a national issue and specifically as a liability crisis in Wisconsin.

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The views and opinions expressed in this report are those of the author and not necessarily those of the reviewers or funding organizations.

The Growing Threat to Economic Development: Wisconsin's Immediate and Critical Need for Legal Reform

Introduction

Called the "Number One" and seemingly silent threat to the development of our future economic health, Wisconsin's deteriorating litigation atmosphere is a critical factor in business retention/expansion and location decisions. Due to recent State Supreme Court decisions and gubernatorial vetoes, Wisconsin is in need of legal reform to ensure that while injured parties are fairly compensated, progress is made in reducing the rapidly growing "tort tax" borne by everyone.

For 10 years, 1995 to 2005, Wisconsin was viewed as having a reasonably fair and efficient legal liability system. Legislative changes in the 1995 legislative session put Wisconsin ahead of most other states in addressing legal reform to create a civil justice system based on common sense and fairness. The key reforms in 1995 included:

- Eliminating the potential of a one percent defendant being forced to pay 100 percent of damages and fairly apportioning damages among defendants based on their actual percentage of negligence;
- Establishing standards for the award of punitive damages to truly reflect the purposes of punitive damages, to punish and deter egregious conduct, and not simply another means of increasing monetary awards; and
- Imposing a cap on the award of noneconomic damages (pain and suffering) in medical malpractice cases.

Based primarily on these reforms, Wisconsin was ranked among the top 10 legal systems for "litigation atmosphere" in the country (U.S. Chamber Institute for Legal Reform, 2004).

Wisconsin's Positive Legal Climate was Diminished

In 2005, in a startling application of judicial activism, the Wisconsin Supreme Court majority went on record advocating what amounted to "social reform" by striking down legislatively directed limits on noneconomic damages in medical malpractice awards, removing limits on product liability responsibility (a company does not have to make the product in question to be held responsible) and by reversing legislative directives on the standard for the award of punitive damage. Currently, Wisconsin's legal climate ranking among states has been dropped to #23 by the 2006 U.S. Chamber of Commerce study and to #30 by a research think tank in California, which was commissioned to do the study by the National Association of Manufacturers (Pacific Research Institute, 2006). Additionally, The Wisconsin Supreme court was singled out for a "Dishonorable Mention" award in a 2005 "Judicial Hellholes" ranking of the worst courts in the United States. Based on four "bad" decisions which will, "place the state at risk, creating a

potential access to healthcare crisis and making businesses think twice about investment in that state" (American Tort Reform Foundation, 2005).

What is Tort Reform?

To the average American consumer, "tort reform," the battle to rein in runaway litigation costs, concerns obscure arguments about powerless individuals bringing suit against giant American corporations. "In fact, lawsuit abuse affects *every* business and every American," according to the Brookings Institute (2004).

The pendulum is swinging nationally on this issue and many states are enacting legal reforms, which are also being considered by the federal government. "Fifty years ago reformers worked to rectify what they believed was a bias in the tort system toward defendants and business interests. Now reformers are working to reduce what appears to many to be abuse of the tort system by those representing plaintiffs (party who initiates a lawsuit)" (Insurance Information Institute, 2006).

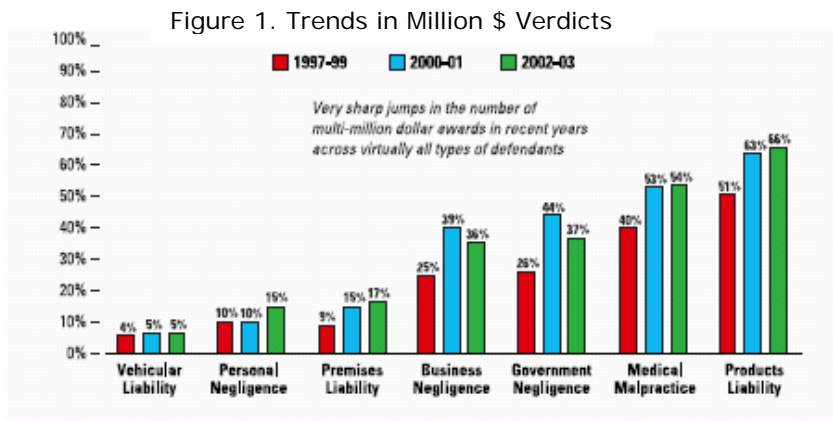
"A tort, French for 'wrong,' is best defined as wrongful conduct by one individual that results in injury to another. A tort has been committed when someone has suffered injury caused by the failure of another person to exercise a required duty of care. The actor is to blame and the injured party is entitled to recover damages. The function of torts is to provide the injured party with a remedy, not to punish the actor" (Pacific Research Institute, 2006).

The issue of tort reform has recently been under study at the national level as well. The Congressional Budget Office (CBO) concluded that: "The 'transaction costs' of the system, particularly attorneys' fees, are too high;" and that, "Punitive damages and compensatory damages for pain and suffering are often awarded arbitrarily, with no beneficial effect on safety" (CBO, 2003).

The U.S. Tort System is Large and Growing Rapidly

"Litigiousness has become a societal problem in the United States. The tort system cost an estimated \$260 billion in 2004 in direct costs, ..." (Insurance Information Institute, 2006). One-third of this amount is personal tort costs arising largely from automobile accidents. Two-thirds is commercial tort costs, \$173.3 billion, which are growing faster than personal tort costs. At these levels, U.S. tort costs are equivalent to an annual "litigation tax" of \$845 per U.S. citizen. In 2006, this "tax" is estimated to be \$1,000 per capita compared to \$12 in 1950 (\$94 adjusted for inflation) (Towers Perrin, 2005).

Having the world's most expensive tort system (twice as much as most industrialized countries) places the American economy at a significant disadvantage internationally. Tort costs have consumed, on average, two percent of Gross Domestic Product (GDP) annually since 1990. Growth in U.S. tort costs since 1950 has far exceeded the growth in Gross Domestic Product (GNP) (Towers Perrin, 2005).



This growth in tort costs is expected to continue as the increase in the frequency of multi-million dollar awards (Figure 1.) is evident across virtually all types of defendants. This includes those in vehicular liability, negligence, medical malpractice and products liability cases. According

to Jury Verdict Research, the average jury award in product liability cases soared some 363 percent from 1997 to 2003, the latest year for which data is available. (Reported in *Tort Excess 2005* with data from Jury Verdict Research.)

Everyone Pays the Growing Tort Tax

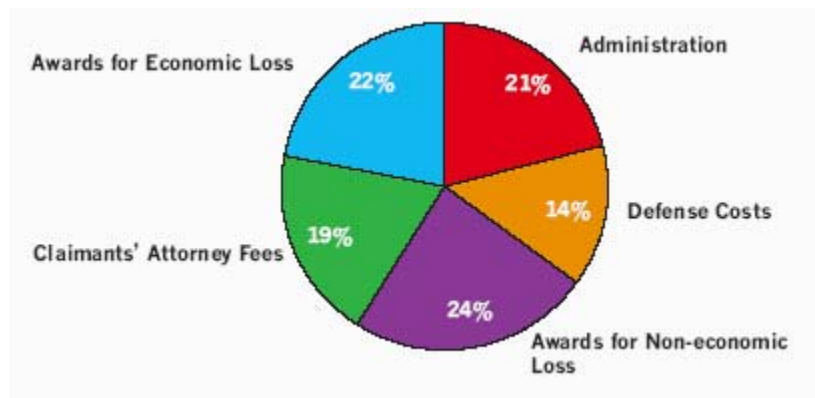
Calculated at \$260 billion in 2004, in 2006 this is equivalent to an annual "litigation tax" that is estimated to be \$1,000 per capita (Towers Perrin, 2005). Is this a lot of money? In 2005, total tort costs were more than total U.S. manufacturing profits. Because of changes in tort law over time, the United States now has the most expensive tort system in the world" (Pacific Research Institute, 2006).

"Whereas an efficient tort system has a potentially important role to play in ensuring that firms have proper incentives to produce safe products, poorly designed policies can mistakenly impose excessive costs on society through forgone production of public and private goods and services" (Council of Economic Advisors (CEA), 2002). In this paper, excessive tort claims are likened to a tax on individuals and firms. The study also examined: "Who pays the Tax?" Estimates indicate payment equivalent to a two percent national tax on consumption or a three percent tax on all wages. "As with any tax, the economic burden of the "tort tax" is ultimately borne by individuals through higher prices, reduced wages, or decreased investment returns" (CEA, 2002).

With controversial issues, the reality is often quite different from the rhetoric. According to some opposing tort reform, "Boiled down, their arguments (tort reform proponents) suggest that the way to make American industry more competitive is to make it more difficult for the sick and injured to sue and collect fair compensation for their corporate-caused injuries" (Public Citizen, not dated).

In reality, the increasing total tort costs mostly feed the system and only 22 percent (Figure 2) of these dollars actually go to claimants for economic damages, such as lost wages or medical expenses (U.S. Chamber Institute for Legal Reform, 2005).

Figure 2. Where Tort Costs Go



Companies being sued are not all "deep pockets"; they are frequently small businesses. A recent study found that "Small businesses bear 68 percent of business tort liability costs, but take in only 25 percent of business revenue" (NERA/AEI-Brookings, 2004).

The Small Business Burden is Large and Hidden

The National Federation of Independent Businesses (NFIB), in response to its members' concerns about legal costs, has conducted several studies on the subject (2002 and 2005) and found: "Overwhelmingly, most disputes are resolved informally out of court. Only 12 percent of legal disputes between small-business owners and other parties are resolved in court, the least frequent method of dispute resolution." There is no data on the direct costs of cases settled out of court. The U.S. tort system is not centralized, which makes collecting comprehensive data about it difficult. Roughly 95 percent of lawsuits over torts are filed in state courts, rather than federal courts, according to Congressional Budget Office (CBO) estimates (CBO, 2003). Moreover, in the vast majority of cases, plaintiffs and defendants reach out-of-court settlements, which terms typically remain private.

Going to trial represents a major threat to small business. In 2005, a study conducted for the SBA Office of Advocacy stated: " Many of the small businesses surveyed tried to settle their case prior to trial, but with mixed results. Those surveyed explained that the main reason why settlement failed was that the opposing party refused to meet and negotiate, preferring to go to court."

Fear of litigation probably stems from the desire to avoid the possible "catastrophic" loss imposed by a jury, which would doom their business. Most small business owners are heavily and personally invested both financially and emotionally in their business, and owners also may be personally financially liable.

Opportunity Costs: The Hidden Costs of Torts

In addition to direct costs of litigation, there may be substantial indirect (often called opportunity) costs. Making choices results in opportunity costs. Opportunity cost measures forgone opportunities. The purchase not made, the product or service not offered or the investment avoided represent potential opportunity costs.

In economic and community development, lost capital investment is a major opportunity cost threat. If investments are not made, jobs are not created and incomes are not earned. Because of the recent Supreme Court decisions and gubernatorial vetoes, Wisconsin has been categorized in the national business press as being unfriendly to business (Wall Street Journal, August 9, 2005). This issue has recently been reiterated in the 2006 Forbes Magazine business rankings of states. Here, Wisconsin was ranked 42nd in "Regulatory Environment," which indexes, among other things, the tort climate in the state.

Torts Negatively Affect Economic Development Decisions

At the recent 2006 Governor's Conference on Economic Development, Wisconsin community leaders and economic development professionals were told that corporate decision makers and the consultants they hire are intimately familiar with controversies that go on at state and local levels. They consider it part of their job to be informed about anti-business attitudes and opinions so as to minimize avoidable risk for their clients – including an unfavorable litigation atmosphere.

The rapid pace of economic development investment decision-making was illustrated by an actual location search made recently by Cushman and Wakefield Consulting Group (a major site location consulting firm). In it the company took just four weeks to determine the three best locations out of dozens of sites in an eight-state area. Obviously, the pressure is on narrowing the list by excluding sites, with weak or negative characteristics. And, capital investment analytical reviews are being made every two to three years for established operations because of global competition and competition among locations internal to the firm.

The vice president of Public Affairs for ALCOA North America echoed the requirements of this process. And, he specifically indicated that legal environment (medical and tort reform) is explicitly considered along with tax burdens and permitting/regulatory activities as part of the evaluation of a state's business climate.

This information is also considered important by the national business press. The fact that Governor Doyle vetoed several bills attempting to address the recent Supreme Court rulings was also dutifully reported in the Wall Street Journal (January 28, 2006). So, the answer is yes that location investment decision makers consider the costs of litigation. In fact, there is one school of thought in economic development that considers the number of lawyers per capita and compares that to business climate (Expansion Management Magazine, 2004).

Controversy over the Size and Role of Economic and Noneconomic Damages

Most of the controversy over the efficiency and equity of tort litigation centers on noneconomic damages (punitive damages and damages for pain and suffering). These costs are often awarded arbitrarily, with no beneficial effect on safety. Most studies agree, criminal law, rather than punitive damages, would seem to be more effective in punishing wrong doers and thereby bringing about benefits to society as whole. The issue of noneconomic damages spans much of the discussion about tort law reform. For a discussion of the legal cases involved and their application to Wisconsin, see the analysis in "Liability Reform Update" by the Hamilton Consulting Group (see "Works Cited" for a link to the paper) (August 21, 2006).

Injured parties are entitled to compensation for all economic losses. The current legal system frustrates this process. Numerous studies have come to the same conclusions. Tort cases most often take too long to resolve, many frivolous claims are filed, injured parties sometimes do not sue and when they do and are successfully awarded damages, they receive less than 50 cents on the dollar (economic plus noneconomic damages). The rest goes to administrative costs and lawyers fees.

The Incidence and Impact of Medical Malpractice Claims

Medical malpractice claims illustrate all of these characteristics. A 2006 Harvard Medical Practice Group study on New York hospital patients found that the vast majority of medical-malpractice suits did not involve actual medical injury (almost four out of ten) – and that most cases in which there was actual injury involved no doctor error.

The study showed that the average claim took five years to settle and the administrative costs (costs of litigating claims, including defense costs and contingency fees paid to plaintiffs' lawyers) took 54 percent of each award. Of particular interest, results from the study showed that the average meritorious award for medical error in New York was \$521,560, only slightly larger than the legislatively established cap declared by the Wisconsin Supreme Court to have been set "irrationally."

However, the study has been hotly debated and opposing sides have come to opposite conclusions using the same data. The one thing almost everyone agrees on, however, is the Harvard study conclusion that: "Finding ways to streamline the lengthy and costly processing of meritorious claims should be in the bulls-eye of reform efforts." Because: "The overhead costs of malpractice litigation are exorbitant."

Medical Malpractice Caps Positively Impact the Number of Doctors

While the question of the direct impact of medical malpractice awards on malpractice insurance costs is bitterly debated, two recent studies have shown that states with medical malpractice caps have more doctors per capita and that caps are especially important in retaining doctors in rural areas. The small but respected federal Agency for Healthcare Research and Quality (AHRQ) found that in 1970, before any states had caps, all states had virtually identical levels of physicians per county (AHRQ, 2003). (The National Bureau of Economic Research (NBER) did the other study.) Thirty years later,

states with caps had over 12 percent more physicians per capita than did those states without caps. (During the period of the study, Wisconsin had a cap in place.) In the last legislative session, the Legislature passed and the governor signed a bill approving a \$750,000 noneconomic damage cap, after previously vetoing a bill limiting damages to \$450,000 for adults and \$550,000 for anyone under age 18.

Supreme Court Found Manufacturers Liable Without Proof of Fault

The Wisconsin Supreme Court also made a precedent setting ruling in a significant product liability case. The day after overruling caps on noneconomic damage awards, the Court held that since lead paint manufacturers are in a better position to pass additional costs along to insurers and consumers, they can be held liable whether or not they made the product in question, the injured party may or may not have used the product and the product may or may not be responsible for the injury. In legal terms, the Court concluded that the "risk contribution" theory could be extended to lead paint claims.

The manufacturers are in a better position to absorb the cost of the injury, said Justice Butler, writing in support of the decision. "They can insure themselves against liability, absorb the damage award, or pass the cost along to the consuming public as a cost of doing business." In lay terms, the Court concluded that it is better to have the manufacturers and/or consumers all share in the cost of the injury rather than place the burden on the innocent plaintiff.

In his dissent, Justice Wilcox said the end result of the majority decision was "manufacturers can be held liable for a product they may or may not have produced, which may or may not have caused the plaintiff's injuries, based on conduct that may have occurred over 100 years ago when some of the defendants were not even part of the relevant market" (*Wall Street Journal*, January 19, 2006). He added, "Simply put, the majority opinion amounts to little more than this court dictating social policy to achieve a desired result".

While the majority decision provides generous benefits to a few, it does little to solve the problem for the many. The targets to address lead paint problems, for example, should be prevention and remediation – not more lawsuits.

In the wake of this ruling, the former dean of the University of Maryland School of Law and author of widely used law school textbooks on torts (including UW Law School) assailed the decision as "the single most radical departure from principles of tort law in recent decades. It is a decision that puts Wisconsin dramatically out of line with the law of any other state in the country" (Gifford, 2005). For more information, Gifford provides a highly detailed legal description of the current state of tort law in this country in a recent issue of the *Washington and Lee Law Review* (Volume 62, Number 3, Summer 2005).

Also commenting on this ruling, the Milwaukee Journal Sentinel stated: "In an overzealous attempt to protect the public, the court went out on a limb so perilously thin

that it leaves companies that may be innocent in product liability lawsuits vulnerable to economically damaging suits" (November 7, 2005).

Fixing the "extended risk contribution theory" which exists only in the State of Wisconsin is probably the number one most critical legal reform target.

Even before the Supreme Court weakened the law, the threat of a lead paint lawsuit by the City of Milwaukee forced the Madison-based Mautz Paint Co. to sell out to national firm Sherman Williams. According to Mautz Chairman Bernhard F. Mautz, grandson of the founder, they sold because, "for the first time in our history we were faced with years of litigation which, even if unsuccessful, could destroy our small company" (Business Journal of Milwaukee, 2001). This recent "guilty till proven innocent" Supreme Court decision has the potential to contribute to further headquarter losses as well as putting a deep chill on corporate expansion plans in Wisconsin.

Court's Decisions Reversed Positive Business Climate Direction

The Wisconsin Legislature had taken steps in 1995 to enhance Wisconsin's business climate by controlling tort costs and institutionalizing fairness. These common sense laws were reversed by the recent Supreme Court decisions. The governor vetoed most of the 2005-06 Legislative enactments that responded to the Supreme Court's decisions. Wisconsin's litigation atmosphere has been changed to one fostering apprehension among existing and prospective employers. New laws are needed. The goal of this legislation should be to restore fairness to our legal system and to bring Wisconsin into parity with other states in order to maintain an economic climate fostering capital investment and job creation.

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- Wisconsin's Legal System Needs Repair - Tort Reform Bullets

- Litigation atmosphere is a critical factor in corporate investment decisions.

Wisconsin's Positive Legal Climate was Diminished

- In the past three years, Wisconsin's legal liability system ranking compared to other states has dropped from 10th to 17th to 23rd. (*U.S. Chamber Institute for Legal Reform*)
- Wisconsin ranked 30th in 2005 *U.S. Tort Liability Index*. (*Pacific Research Institute*)
- Other states are enacting reforms while Wisconsin's earlier reforms are being dismantled. (*U.S. Chamber of Commerce*)

The U.S. Tort System is Large and Growing Rapidly

- Total tort costs are growing faster than the US economy, thus increasing their share relative to other economic sectors. (*Towers Perrin*)

What is Tort Reform?

- Tort reform is not about denying compensation; it is about efficiently and fairly settling claims.
- Only 20 percent of tort costs go to reimburse injured parties for economic damages. (*Council of Economic Advisors*)

Everyone Pays the Growing Tort Tax

- "Every business and every American" pays a "Tort Tax." (*Brookings Institute*)
- The "Tort Tax" is growing rapidly and is estimated at \$1,000 per capita in 2006. (*Towers Perrin*)

The Small Business Burden is Large and Hidden

- Small businesses bear 68 percent of business tort liability costs, but take in only 25 percent of business revenue. (*NERA Economic Consulting/AEI-Brookings*)
- Only 12 percent of small business legal disputes are settled in court. (*NFIB*)
- Small businesses try to avoid court at all costs in order to avoid "catastrophic" jury awards. (*SBA Office of Advocacy*)

Opportunity Costs: The Hidden Costs of Torts

- Indirect tort cost measures opportunities lost (forgone).
- Economic development investment not made is an "opportunity cost" of an inequitable legal system.
- Wisconsin ranked 42nd in "Regulatory Environment." (*Forbes*, August 16, 2006)

Torts Negatively Affect Economic Development Decisions

- The Wall Street Journal (8/9/05) has characterized Wisconsin as "Alabama North."
- A state's litigation atmosphere is a critical factor in business retention/expansion/location decisions. (*Expansion Management Magazine*)
- Capital investment decisions and every two to three year investment re-evaluations are the norm and are made rapidly in the face of uncertainty. Litigation fears increase the uncertainty of business investment decisions. (*ALCOA North America/Cushman & Wakefield*)

Controversy over the Size and Role of Economic and Noneconomic Damages

- Punitive damages are the civil justice attempt to punish and deter.
- Punitive damage assessments are considered to be less effective than criminal law in promoting corrective behavior thereby increasing public safety.

The Incidence and Impact of Medical Malpractice Claims

- Four out of ten medical malpractice suits do not involve actual medical injury. (*Harvard School of Public Health*)
- Legal reform efforts should focus on streamlining the lengthy and costly process of settling meritorious claims. (*Harvard School of Public Health*)
- Administrative costs (including lawyers' fees) take 54 percent of the average successful tort claim. (*Harvard School of Public Health*)

Medical Malpractice Caps Positively Impact the Number of Doctors

- States with medical malpractice caps have more doctors per capita. (*Agency for Healthcare Research and Quality*)
- States with medical malpractice caps find it easier to retain doctors in rural areas. (*National Bureau of Economic Research*)

Supreme Court Found Manufacturers Liable Without Proof of Fault

- Wisconsin "manufacturers can be held liable for a product they may or may not have produced, which may or may not have caused the plaintiff's injuries . . ." (*Justice Wilcox*)
- Lead paint litigation provides generous benefits to a select few but does little to improve the safety of the public at large.
- Wisconsin's recent "guilty till proven innocent" Supreme Court decision has the potential to contribute to further headquarter losses as well as putting a deep chill on corporate expansion plans in Wisconsin.

Court's Decisions Reversed Positive Business Climate Direction

- Recent State Supreme Court decisions and gubernatorial vetoes have reversed Wisconsin's drive for regulatory fairness and certainty. (*Wall Street Journal*, 1/28/06)
- Wisconsin needs new laws to restore legal system fairness.
- Wisconsin needs legal reform to help bring it in line with other states.
- "The impact of a state's legal system on economic growth is statistically significant. A state that imposes a capricious or arduous court system on businesses is likely stunting its growth compared with a state that offers a more reasonable structure." (*U.S. Chamber Institute for Legal Reform*)