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Keith N. Hylton

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## Fee Shifting and Incentives to Comply with the Law

Keith N. Hylton\*

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## I. INTRODUCTION

Law and economics is a top-heavy discipline, in the sense that it is largely theoretical. Empirical tests of its claims have been carried out only recently, and a great deal remains to be done. The larger part of the recent wave of empirical law and economics research, however, examines the litigation process. This research has focused on the frequencies with which lawsuits are brought and with which they are settled.<sup>1</sup> Surprisingly, empirical researchers<sup>2</sup> have given little attention to the theoretical literature that makes predictions concerning incentives to comply with legal rules and the optimality of compliance equilibria.<sup>3</sup> This lack of attention is disappointing because compliance theory has a greater claim to being "core," or central, to the law and economics literature than does litigation theory.

The reason for the uneven fit between empirical and theoretical research agendas is clear: it is difficult to observe the effects of legal stan-

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1. For recent contributions, see Patricia Munch Danzon and Lee A. Lillard, *Settlement Out of Court: The Disposition of Medical Malpractice Claims*, 12 J. Legal Stud. 345 (1983); Edward A. Snyder and James W. Hughes, *The English Rule for Allocating Legal Costs: Evidence Confronts Theory*, 6 J. L. Econ. & Org. 345 (1990); Gary M. Fournier and Thomas W. Zuehlke, *Litigation and Settlement: An Empirical Approach*, 71 Rev. Econ. & Stats. 189 (1989); Theodore Eisenberg, *Testing the Selection Effect: A New Theoretical Framework with Empirical Tests*, 19 J. Legal Stud. 337 (1990).

2. See, for example, Stephen D. Sugarman, *Doing Away with Tort Law*, 73 Cal. L. Rev. 555, 587-89 (1985) (discussing empirical studies of the deterrent effect of tort law). Workers' compensation has received more attention from empirical researchers than most other areas of tort law. For an example of the growing body of rigorous and detailed empirical investigations of the effects of workers' compensation, see generally Michael J. Moore and W. Kip Viscusi, *Compensation Mechanisms for Job Risks: Wages, Workers' Compensation, and Product Liability* 3 (Princeton U., 1990).

3. A significant part of the work at the foundation concerns tort rules. See, for example, Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* 3 (Yale U., 1970); William M. Landes and Richard A. Posner, *The Economic Structure of Tort Law* 1 (Harvard U., 1987); Steven Shavell, *Economic Analysis of Accident Law* 1 (Harvard U., 1987). See also John Prather Brown, *Toward an Economic Theory of Liability*, 2 J. Legal Stud. 323 (1973); Peter Diamond, *Single Activity Accidents*, 3 J. Legal Stud. 107 (1974); A. Mitchell Polinsky and Daniel L. Rubinfeld, *The Welfare Implications of Costly Litigation for the Level of Liability*, 17 J. Legal Stud. 151 (1988); Keith N. Hylton, *Costly Litigation and Legal Error Under Negligence*, 6 J. L. Econ. & Org. 433 (1990).

dards on ordinary behavior outside of the courtroom. How, for example, should one go about determining the effect of the negligence rule on the caretaking behavior of drivers? Nature provides few experiments and the cost of creating the required experiments is prohibitive. In the area of fee shifting, for example, courts and commentators have long justified deviations from the American fee shifting rule by referring to effects on compliance incentives.<sup>4</sup> Not a shred of empirical evidence on the compliance effects of alternative fee shifting rules exists, however, and it is unlikely that it ever will, given the cost of the required experiments.

This Article aims to construct a partial bridge between predictive and empirical research on compliance with legal rules. The Article examines the effects of alternative fee shifting rules on incentives to comply with the law, to litigate, and to settle disputes, by simulating a model of litigation that incorporates compliance effects.<sup>5</sup>

This Article examines four fee shifting rules: the American rule, which requires each party to pay his own litigation costs; the British rule, which requires the losing party to pay the winning party's costs in addition to his own; the "Proplaintiff" rule, which requires the plaintiff to pay only his own costs if he loses and no costs otherwise; and the "Prodefendant" rule, which requires the defendant to pay only his own costs if he loses and no costs otherwise. The Article also examines the compliance effects of fee shifting under alternative "information regimes." The first information regime assumes that the defendant knows whether he violated the legal standard, but the plaintiff does not know. In the second, the plaintiff knows whether the defendant violated the legal standard, but the defendant does not know. In the third, neither party knows with certainty whether the defendant violated the legal standard.

The Article concludes that fee shifting in favor of prevailing plaintiffs generates the greatest incentive to comply with the law, and this

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4. See, for example, *Atchison, Topeka & Santa Fe R.R. Co. v. Matthews*, 174 U.S. 96, 98 (1899) (stating that the purpose of a fee shifting statute is to "secure the utmost care on the part of railroad companies to prevent the escape of fire from their moving trains"). See also *Hindman v. Oregon Short Line R.R. Co.*, 32 Idaho 133, 178 P. 837 (1918); *Daly v. Look*, 267 S.W.2d 77 (Ky. Ct. App. 1954).

5. This Article expands on an earlier one. See Keith N. Hylton, *Litigation Cost Allocation Rules and Compliance with the Negligence Standard*, 22 J. Legal Stud. 455 (1993). The earlier article presents a new economic model of litigation, discusses its implications for the economic theory of litigation, and briefly describes the results of a simulation of the model. This Article expands on the previous one by presenting the results of simulating several versions of the litigation model and by discussing in more detail the implications for fee shifting law. Several versions of the model are explored in this Article so that the normative implications could be considered somewhat robust. In short, while the first article focused on litigation theory, this Article emphasizes and expands on the normative implications.

result holds in each information regime examined. The reason is simple: litigation costs are a significant obstacle to victims who wish to bring suit. The Proplaintiff rule nearly eliminates this obstacle. The Article also reveals that *fee shifting in favor of prevailing plaintiffs generates the least litigation*.<sup>6</sup> The reason is that the greater incentive to sue generates greater compliance incentives. Thus, under the Proplaintiff rule, the pool of defendants contains the smallest proportion of guilty defendants relative to the other fee shifting rules. Since plaintiffs will then rationally estimate that the probability that a defendant is innocent is reasonably high, they are more likely to settle under the Proplaintiff rule.

The Article finally considers the implications of these results for Supreme Court decisions on fee shifting. The results suggest that the best fee shifting rule is one that shifts fees in favor of prevailing plaintiffs and against plaintiffs only in cases of bad faith litigation,<sup>7</sup> which is the standard the Supreme Court adopted in interpreting the two-way fee shifting provision of the Civil Rights Attorney's Fees Awards Act of 1976. In addition, the majority and dissenting opinions in *Evans v. Jeff*

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6. More precisely, the probability of litigation, *given an accident*, is lowest under the Proplaintiff rule. It follows that these results understate the extent to which the Proplaintiff rule reduces litigation. Because the Proplaintiff rule generates the highest level of compliance, it leads to the lowest accident frequency. Thus, the base of accidents from which disputes arise is lowest under the Proplaintiff rule. The frequency of litigation is the probability of an accident multiplied by the probability of litigation, given an accident. The Proplaintiff rule minimizes both terms.

7. This rule would be "best" in the sense that it leads to the highest level of compliance and the least litigation. One might say that this is economically efficient, but this Article does not make that claim.

This Article is not the first to argue that fee shifting in favor of prevailing plaintiffs is desirable on incentive grounds. Incentive arguments have been made in recent articles defending proplaintiff fee shifting in civil rights litigation. See, for example, Jeffrey S. Brand, *The Second Front in the Fight for Civil Rights: The Supreme Court, Congress, and Statutory Fees*, 69 Tex. L. Rev. 291 (1990); James Kraus, *Ethical and Legal Concerns in Compelling the Waiver of Attorney's Fees by Civil Rights Litigants in Exchange for Favorable Settlement of Cases Under the Civil Rights Attorney's Fees Awards Act of 1976*, 29 Vill. L. Rev. 597 (1984). While this Article does not aim to detract from either of these articles, especially the riveting argument presented by Kraus, neither piece focuses on general incentive issues, and neither argues for a general rule shifting fees in favor of prevailing plaintiffs. For the most impressive statement of the argument that a general rule shifting fees in favor of prevailing plaintiffs is desirable on incentive grounds, see John Leubsdorf, *Recovering Attorney Fees as Damages*, 38 Rutgers L. Rev. 439 (1986).

In addition to incentive-based arguments, a large literature evaluates fee shifting on "justice" grounds. See Albert A. Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 Cal. L. Rev. 792 (1966); *First Report of the Judicial Council of Massachusetts*, 11 Mass. L. Q. 1, 64 (1925); Arthur L. Goodhart, *Costs*, 38 Yale L. J. 849 (1929); Charles T. McCormick, *Counsel Fees and Other Expenses of Litigation as an Element of Damages*, 15 Minn. L. Rev. 619 (1931); Richard Cosway, Note, *Attorney's Fees as an Element of Damages*, 15 U. Cin. L. Rev. 313 (1941); Note, *Distribution of Legal Expense Among Litigants*, 49 Yale L. J. 699 (1940); William B. Stoebeuck, *Counsel Fees Included in Costs: A Logical Development*, 38 U. Colo. L. Rev. 202 (1966); Warren Watson, *A Rationale of the Law of Costs*, 16 Cent. L. J. 306 (1883). This Article does not discuss the justice arguments.

*D. and Marek v. Chesny* assume that a tension exists between settlement and compliance incentives. This assumption may simply be invalid; no tension or necessary tradeoff may exist between the settlement- and compliance-enhancing properties of fee shifting rules.

## II. THE ECONOMIC THEORY OF FEE SHIFTING

As in economics literature generally, both positive and normative economic analyses of fee shifting exist. The positive analyses typically aim to predict the effect of fee shifting rules on incentives to bring suit or to settle disputes. The normative work aims to prescribe an optimal fee shifting rule. Normative analysis is more general in the sense that nothing constrains the normative analyst to examine existing fee rules.

### A. Normative Analyses of Fee Shifting: The Public Subsidization Argument

Sheldon Amos likely presented the first normative analysis of fee shifting.<sup>8</sup> Amos argued that litigation costs should be borne entirely by the state because litigation results from uncertainty in the law,<sup>9</sup> and legal uncertainty in turn exists because the state has been insufficiently clear in framing legal rules, either in the form of court decisions or statutes.<sup>10</sup>

The problem of designing an optimal fee shifting rule did not appear in legal literature again until Kenneth Dayton's discussion in the *Annals of the American Academy* in 1933.<sup>11</sup> Dayton refined Amos's argument by proposing that legal fees be borne by the state only with respect to legal issues that affect the public. With respect to factual issues, or legal issues that affect only the parties to the dispute, the parties should bear the litigation costs for two reasons. First, the uncer-

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8. Sheldon Amos, *The Science of Law* (D. Appleton & Co., 1875). Amos's book was the first attempt to provide some theoretical examination of the law of costs. If one takes a very broad view of the term "normative theory," one could argue that Blackstone provided a normative analysis when he referred to statutes that "very equitably gave the defendant, if he prevailed, the same costs as the plaintiff would have had, in case he had recovered." William Blackstone, 3 *Commentaries on the Laws of England* \*399. This Article does not take such a broad view of the term "normative theory."

9. Amos, *The Science of Law* at 316-17. Amos's proposal, when viewed as a fee shifting rule, suggests that all fees should be shifted to the state.

10. Of course, a large amount of literature exists on the certainty of legal rules. For recent contributions, see William M. Landes and Richard A. Posner, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J. L. & Econ. 249 (1976); Anthony D'Amato, *Legal Uncertainty*, 71 Cal. L. Rev. 1 (1983). The notion that certain fee shifting rules contribute more to legal certainty than others is explored in J. Robert S. Prichard, *A Systemic Approach to Comparative Law: The Effect of Cost, Fee, and Financing Rules on the Development of the Substantive Law*, 17 J. Legal Stud. 451 (1988). See also D'Amato, 71 Cal. L. Rev. at 30 n.62.

11. Kenneth Dayton, *Costs, Fees, and Expenses in Litigation*, 167 *Annals* 32 (1933).

tainty in these areas is not the result of the state's sloppiness in framing legal rules. The second and more interesting reason Dayton offered is that resolution of legal issues generally benefits many parties, while resolution of factual issues generally benefits only the parties to the dispute. For this reason litigation of legal issues provides a public good; it is costly to provide, but once provided its benefits spill over to many individuals. Without state subsidization, legal issues would be litigated at less than the optimal rate.<sup>12</sup>

The crucial weakness in the Amos-Dayton public subsidization argument is the assumption that legal uncertainty is entirely attributable to the state. Two types of legal uncertainty exist. One type is uncertainty in the *framing* of legal rules, which results because the applicable legal rule was either never stated by a court or legislature, or stated at too general a level to indicate clearly the scope of its application.<sup>13</sup> The second type of uncertainty concerns the *stability* of a legal rule.<sup>14</sup> Even if it is clear to the parties that the rule applies to them, they still may be unsure that the rule will stand for a period of time sufficient to allow

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12. The theory of public goods posits that such goods are generally undersupplied by the market. See Jack Hirshleifer, *Price Theory and Applications* 478-82 (Prentice-Hall, 4th ed. 1988). Pro-plaintiff fee shifting provides an alternative to public subsidization that might address some of the problems identified by the public goods theory. Because plaintiffs generally will have insufficient incentives to bring suit when the claim will establish a right that benefits many, pro-plaintiff fee shifting will correct the incentive problem to some extent by encouraging plaintiffs to sue. The problem with this proposition is that the full litigation costs are still borne by the parties; therefore, they will have an incentive to settle the dispute. Disputes that are settled do not produce the public benefits Dayton's proposal seeks. Thus, if the public good aspects of litigation are substantial, the state should subsidize some portion of expenses in order to enhance incentives to bring suit and *reduce* incentives to settle. For a more recent version of the public goods argument against settlement, see Owen Fiss, Comment, *Against Settlement*, 93 Yale L. J. 1073 (1984).

13. Framing uncertainty has been of greatest concern in the literature on legal uncertainty. See, for example, D'Amato, 71 Cal. L. Rev. at 1 (cited in note 10). It seems fair to say that the entire field of statutory construction is concerned with this type of uncertainty. The classic example of uncertainty in framing is a statute described originally by Puffendorf and later by Blackstone that forbade a layman to "lay hands" on a priest. See William Blackstone, 1 *Commentaries on the Laws of England* \*59. Courts held that the statute applied to an individual who hurt a priest with a weapon, even though a literal construction would not have supported this result. Blackstone defended this interpretation as consistent with the then-popular use of the term "lay hands," which he understood to mean "to harm." Id. Bentham criticized Blackstone's interpretation and offered an alternative. He proposed that the purpose of the statute was to prevent local justice authorities from apprehending priests; otherwise, it would have made little sense to restrict its application to laymen. Jeremy Bentham, *A Comment on the Commentaries: A Criticism of William Blackstone's Commentaries on the Laws of England* \*15-18. Thus, a rule forbidding a layman to lay hands on a priest is a source of framing uncertainty because it generates at least three plausible interpretations: (1) a layman cannot touch a priest; (2) a layman cannot hurt a priest; and (3) a layman cannot arrest a priest.

14. See Bruno Leoni, *Freedom and the Law* 77-96 (D. Van Nostrand Co., 1961) (emphasizing the distinction between certainty in framing and certainty in stability).

them to plan their affairs with the understanding that the rule will remain in effect.

The first type of uncertainty—ambiguity in framing—seems to be attributable to the state. It is not at all clear, however, that litigation in this area produces a public good. Dayton noted that issues can be divided into factual and legal categories. Factual issues generally do not exhibit public good characteristics; therefore, the cost of factual-issue litigation should be borne entirely by the parties to the dispute. Dayton failed to note, however, that legal issues can be subdivided further into two categories. With respect to one set of legal issues, the applicable rule is predictable because the parties have developed a set of norms that operate as law, or because the rules that should govern are clear or obvious to the parties even though no court has ever provided a stamp of approval.<sup>15</sup> In the other set of legal issues, the rules that should govern are unpredictable, either because customs or norms have not developed and the appropriate norms are unclear, or because the norms that have developed are unsustainable in the absence of an explicit agreement.<sup>16</sup> Litigation provides a public good only in the latter subcategory; therefore, it is only within this subcategory that public subsidization of litigation can be justified by the public good theory. The question that remains for the Amos-Dayton argument is how large the second subcat-

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15. This point refers to implicit agreements, such as coordination rules, that sometimes govern social interaction. An example of a coordination rule is "drive on the right side of the street." When such rules have developed without the help of the state, litigation that simply reproduces the accepted norm provides no public good. Litigation that overturns the accepted norm provides a public good only if the new rule Pareto dominates the original rule. Rule A Pareto dominates Rule B if a switch from B to A improves the welfare of at least one person and leaves everyone else in at least the same position. See, for example, Hirshleifer, *Price Theory and Applications* at 462 (cited in note 12).

A self-enforcing norm may develop without the help of the state if no party has an incentive to deviate from the norm once it is established. For a game-theoretic explanation of cooperative norms, see Robert Axelrod, *The Evolution of Cooperation* (Basic, 1984). The theory of cooperative norms goes back to Hume and was expanded by Hayek. See F. A. Hayek, 1 *Law, Legislation, and Liberty: Rules and Order* (U. of Chicago, 1973).

Blackstone provided the most extreme version of this view of law (incidentally, he was the first to offer a theory of legal uncertainty). Blackstone argued that common law was drawn from the set of implicit agreements governing social interaction. See Blackstone, 1 *Commentaries* \*63-92 (cited in note 13). It follows from this proposition that as long as those agreements are accepted and understood, litigation cannot provide a public good. Common law generally was clear under Blackstone's theory because it existed independently of the state's efforts to articulate or codify it. Blackstone's theory is resuscitated in Leoni's book. See Leoni, *Freedom and the Law* at 77-96 (cited in note 14).

16. Nuisance law provides a rich source of examples of regime changes that require the establishment of new norms. Nuisance law has long recognized that a reasonable activity can become unreasonable as the result of change in the surrounding community. When such a change occurs, the appropriate norms are no longer clear. See, for example, *Ensign v. Walls*, 323 Mich. 49, 34 N.W.2d 549 (1948) (holding that a dog breeder's business became a nuisance within the community that developed around it).



egory is, for if it contains only a minor set of issues, then the public good theory generates the conclusion that no (or virtually no) litigation costs should be borne by the state. If disputes that are governed by unpredictable legal rules arise infrequently, then the administrative costs of identifying this set of disputes and applying a state reimbursement policy could easily outweigh the potential benefits.

Now consider uncertainty with respect to the stability of a legal rule. Here the Amos-Dayton argument rests on an even weaker foundation because stability-based uncertainty is not attributable entirely to the state; it often results from efforts of private parties to overturn legal rules.<sup>17</sup> Once this fact is taken into account, an important cost ignored by the Amos-Dayton analysis reveals itself. If one of the parties is able to persuade the court to adopt its preferred statement of a legal rule, then the door is opened under state subsidization to litigants whose sole aim is to rewrite the law in a fashion that suits them.<sup>18</sup> Public subsidization of such efforts would generate an endless supply of litigants, likely an undesirable result.<sup>19</sup>

The argument for public subsidization relies on the unproven and perhaps unprovable central assumption of legal positivism: that uncertainty in the law is attributable entirely to the state. It is beyond the scope of this Article to resolve this issue. It should be sufficient to note, however, that because it is unresolved, the Amos-Dayton argument for public subsidization is incomplete. Setting aside the public subsidiza-

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17. It may be helpful to distinguish types of stability or intertemporal uncertainty in legal rules. One type concerns statutes; the other concerns common-law rules. In neither case is stability uncertainty entirely attributable to the state. The state is certainly responsible for setting up institutions that permit stability-based uncertainty to result. Nevertheless, private efforts to encourage legislation or to litigate in order to change the law are important sources of stability uncertainty. In addition, the ease with which a legal rule can be changed encourages efforts to change the rule. Thus, if judges show no reluctance to reverse established rules, private parties will be all the more willing to litigate in order to reverse a given rule. It follows that stare decisis enhances legal certainty not only by reducing the likelihood that the court will overturn a legal rule in a given case, but also by reducing the number of challenges to legal rules.

18. See Paul H. Rubin, *Common Law and Statute Law*, 11 J. Legal Stud. 205 (1982). Rubin argues that common-law rules will not necessarily tend toward wealth maximization because some litigants will approach the litigation process in the same manner in which they would approach the legislative process; they will litigate with the intention of establishing legal rules that have the effect of transferring wealth from other parties to themselves. *Id.* at 222. Rubin attributes his thesis to Gordon Tullock. See Gordon Tullock, *Evolutionary Theory in Law and Economics*, in Richard O. Zerbe, Jr. and Paul H. Rubin, eds., 4 *Research in Law and Economics* 74, 79-80 (JAI, 1982).

19. It is not clear that this result would be desirable for the reasons given by Tullock and Rubin. See note 18. If the litigation process is largely an attempt to generate rules that transfer wealth, the net effect of litigation is to reduce society's wealth. The end result is a transfer from A to B (which leaves society's wealth the same) after incurring litigation costs, which ultimately reduces society's wealth.

tion issue, the remainder of this Article will examine fee shifting under the assumption that the parties bear the litigation costs.

### B. Positive Economic Analyses of Fee Shifting

This subpart examines the positive economic analyses of fee shifting. Although more recent, the volume of literature based on positive theory now exceeds that based on the normative theory.<sup>20</sup>

#### 1. The Mause-Shavell Analysis

Statements concerning the incentive effects of fee shifting can be found in some of the earliest literature on the subject,<sup>21</sup> but scholars did not attempt an economic analysis of the incentive effects until Philip J. Mause's contribution.<sup>22</sup> Mause compared British and American fee rules to demonstrate that the claim that fee shifting would reduce court congestion is invalid as a general proposition. Mause concluded that the effect a shift to the British rule would have on the total amount of litigation is ambiguous; although pessimistic plaintiffs would be discouraged from litigating under the British rule, optimistic plaintiffs would be encouraged.<sup>23</sup> Mause also concluded that fee shifting would be desirable in cases involving small but legitimate claims.<sup>24</sup>

Relying on the litigation model developed by Landes, Gould, and Posner,<sup>25</sup> Steven Shavell carried out the next positive analy-

20. Because of the size of the literature, this Article discusses only the portions that serve best as a background for Part II, which presents a new model of litigation. Some recent important contributions to the theory of fee shifting that are not discussed in this Part are Lucian Arye Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 Rand J. Econ. 404 (1984); Avery Katz, *Measuring the Demand for Litigation: Is the English Rule Really Cheaper?*, 3 J. L. Econ. & Org. 143 (1987); Jennifer F. Reinganum and Louis L. Wilde, *Settlement, Litigation, and the Allocation of Litigation Costs*, 17 Rand J. Econ. 557 (1986); John C. Hause, *Indemnity, Settlement, and Litigation, or I'll Be Suing You*, 18 J. Legal Stud. 157 (1989).

21. The incentive arguments in the early discussions generally consisted of little more than an assertion that cost shifting would have the desired effect—that is, shifting costs would reduce court congestion or give the poor plaintiff a greater incentive to sue. For early discussions of the incentive effects of fee shifting, see Dayton, 167 Annals at 32 (cited in note 11); *First Report*, 11 Mass. L. Q. at 63 (cited in note 7); Goodhart, 38 Yale L. J. at 849 (cited in note 7); Howard Greenberger, *The Cost of Justice: An American Problem, An English Solution*, 9 Vill. L. Rev. 400 (1964); Calvin A. Kuenzel, *The Attorney's Fee: Why Not a Cost of Litigation?*, 49 Iowa L. Rev. 75 (1963); Note, *Use of Taxable Costs to Regulate the Conduct of Litigants*, 53 Colum. L. Rev. 78 (1953).

22. Philip J. Mause, *Winner Takes All: A Re-examination of the Indemnity System*, 55 Iowa L. Rev. 26 (1969).

23. *Id.* at 31.

24. *Id.* at 33-34.

25. See William M. Landes, *An Economic Analysis of the Courts*, 14 J. L. & Econ. 61 (1971); John P. Gould, *The Economics of Legal Conflicts*, 2 J. Legal Stud. 279 (1973); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. Legal Stud. 399 (1973).

sis.<sup>26</sup> Following Mause, Shavell asked whether victims are more likely to bring suit under the American or the British rule, and whether, given suit, settlement is more likely under the American or the British rule. Shavell expanded upon Mause's analysis by using a mathematical model and by examining, in addition to the American and British rules, one-way shifting in favor of the plaintiff and in favor of the defendant.

Let  $P_p$  be the plaintiff's estimate of the probability of a verdict in his favor, and  $P_d$  be the defendant's estimate of the probability of a verdict in the plaintiff's favor. Let  $C_p$  be the plaintiff's cost of litigating and  $C_d$  be the defendant's cost of litigating. Let  $J$  be the judgment. A plaintiff will bring suit under the American rule when

$$P_p J > C_p,$$

and under the British rule when

$$P_p J > (1 - P_p)(C_p + C_d).$$

Comparing the two requirements, suit is more likely under the British rule if

$$P_p > C_d / (C_p + C_d).$$

Thus, the more optimistic the plaintiff, other things being equal, the more likely it is that the plaintiff will bring suit under the British rule.

In considering incentives to settle, Shavell assumed that settlement occurs only if the plaintiff's minimum settlement demand is less than the defendant's maximum settlement offer.<sup>27</sup> Under the American rule the plaintiff's minimum demand is  $P_p J - C_p$ ; the defendant's maximum offer is  $P_d J + C_d$ . The difference between the maximum offer and the minimum demand is known as the *settlement* or *contract zone*.<sup>28</sup> Given suit, settlement occurs under the American rule if

$$(P_p - P_d)J < (C_p + C_d).$$

That is, settlement occurs if the perceived difference in the stakes is less than the total cost of litigation.<sup>29</sup>

26. See Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. Legal Stud. 55 (1982).

27. *Id.* at 56-57.

28. See Linda R. Stanley and Don L. Coursey, *Empirical Evidence on the Selection Hypothesis and the Decision to Litigate or Settle*, 19 J. Legal Stud. 145, 147 (1990).

29. Shavell, 11 J. Legal Stud. at 63 (cited in note 26). If the parties have different expectations of  $J$  (given a verdict for the plaintiff), they would settle only if  $P_p J_p - P_d J_d < C_p + C_d$ . Why might parties have different expectations of  $J$ , conditional on a verdict for the plaintiff? One possibility is that plaintiffs are "one shot" litigants and defendants are "repeat players." The repeat players may have a high conditional expectation of  $J$  because they anticipate future litigation. For a theory of litigation that relies largely on this notion, see Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 L. & Soc'y Rev. 95 (1974).

Under the British rule, the plaintiff's minimum settlement demand is  $P_p J - (1 - P_p)(C_p + C_d)$ ; the defendant's maximum settlement offer is  $P_d J + P_d(C_p + C_d)$ . Given suit, settlement occurs under the British rule if

$$(P_p - P_d)J < (1 - P_p + P_d)(C_p + C_d).$$

These conditions imply that settlement is generally more likely under the American rule. This is true because if the plaintiff is more optimistic than the defendant (a necessary though not sufficient condition for litigation), the British rule has the effect of reducing the sum of the expected legal costs. Alternatively, the British rule raises the stakes, which makes litigation more attractive to the parties when the plaintiff places a higher estimate on the likelihood of his winning than does the defendant.<sup>30</sup>

In an extension of the Mause-Shavell framework, John Donohue has recently argued that the Coase theorem implies that settlement frequencies should be the same under the British and American rules.<sup>31</sup> The reason is that if the plaintiff is relatively optimistic, both parties, under certain conditions, will be made better off ex ante by agreeing to comply with the British rule.<sup>32</sup> Given that the parties will have an incentive to adopt the cost allocation rule that maximizes joint wealth, one should observe the same settlement rates under the American and British rules. The rules simply are default provisions around which the parties are free to bargain.

By assuming that parties have the same conditional expectation of  $J$ , given a verdict for the plaintiff, the theory outlined in the text rules out the possibility that litigation is driven by differences in the conditional expectations of  $J$ . Several reasons for this approach exist. The first is simplicity. The second and most important is that the litigation model examined in this Article focuses on differences in estimates of the likelihood of plaintiff victory. Taking into consideration differences in the conditional expectation of  $J$  would divert attention from the central concern. Third, the case for relying on differences in the conditional expectation of  $J$  in any effort to explain litigation is far from settled empirically. See Keith N. Hylton, *Asymmetric Information and the Selection of Disputes for Litigation*, 22 J. Legal Stud. 187 (1993).

30. Shavell, 11 J. Legal Stud. at 59 (cited in note 26). Mause also made this point. See Mause, 55 Iowa L. Rev. at 31 (cited in note 22). The conclusion is inconsistent with the Coase theorem, which would suggest that settlement rates would be the same under either cost allocation rule. John J. Donohue III, *Opting for the British Rule, or if Posner and Shavell Can't Remember the Coase Theorem, Who Will?*, 104 Harv. L. Rev. 1093, 1099-109 (1991). For further discussion of the Coase theorem and settlement, see notes 31-36 and accompanying text.

31. Donohue, 104 Harv. L. Rev. at 1099.

32. If  $P_p > C_d/(C_p + C_d) > P_d$ , under the British rule the plaintiff will attach a greater expected value to the right to bring suit, and the defendant will bear less expected liability. Thus, both parties will be better off ex ante by agreeing to comply with the British rule. Given the conditions, an agreement to comply with the British rule will be Pareto optimal. Donohue envisions a lawsuit with the American rule operating in the background, in which the parties agree during settlement negotiations to comply with the British rule if they fail to settle the case. *Id.*

The Coase theorem identifies some important theoretical issues in the examination of settlement incentives. Because it is unlikely to explain settlement patterns, however, this Article does not rely on Coase's theory. No empirical support for the theory as an explanation of settlement patterns exists.<sup>33</sup> More importantly, the theory suffers from an important flaw: it applies an argument originally established under different liability rules to an inappropriate setting. To be more specific, the Coase theorem demonstrates that in a regime of frictionless bargaining the parties will adopt the cost-minimizing set of precautions, regardless of the liability rule in effect. In other words, if the rule in effect is strict liability, the parties may negotiate a waiver of liability if such an arrangement is wealth maximizing, with appropriate side payments exchanged.

In the litigation problem Donohue analyzed, the parties attempting to settle their case are doing something analogous to negotiating a waiver of liability. The notion that they might contractually arrange for a different fee shifting rule would require the parties to suspend settlement negotiations in order to negotiate over a fee shifting rule that maximizes wealth, in the event that they choose to litigate. How likely is this to occur? Would not the offeree doubt the sincerity of the offeror's professed desire to settle the dispute if the offeror proposes adopting a new fee shifting rule if settlement negotiations fail? Would not such an offer be taken as a signal of a desire to litigate under the proposed fee shifting rule?

This general criticism applies to the Coase theorem as well. Some contractual provisions signal to the other party an intention not to comply with the general aim of the contract;<sup>34</sup> by proposing such provisions parties may shoot themselves in the foot. For example, a sports player may be reluctant to propose an injury clause, for fear that the proposal will be taken as a sign of a "malingering" nature.<sup>35</sup> The critique applies

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33. Id.

34. See Kathryn E. Spier, *Incomplete Contracts and Signalling*, 23 Rand J. Econ. 432, 433 (1992).

35. This is a nice example mentioned in Spier, 23 Rand J. Econ. at 433. Spier argues that merely asking for certain types of contractual provisions may signal important characteristics of the proponent. This signal is important in an environment in which characteristics are not observable. If a sports player signals that he is a malingerer, then the team owner will reassess the terms of the contract in light of this signal. In an equilibrium in which only malingerers ask to be paid in full while injured, contracts generally will fail to include such injury clauses.

Barry Nalebuff introduced the intuition behind Spier's argument in the litigation context. See Barry Nalebuff, *Credible Pretrial Negotiation*, 18 Rand J. Econ. 198 (1987). Nalebuff's argument runs as follows: Suppose that plaintiffs cannot observe the "value" of their claims but defendants can. In order to maintain the credibility of their claims to sue, plaintiffs generally will overstate their damages. To ask for too little, in Nalebuff's model, would risk revealing that the plaintiff's threat to sue is not credible. Id. at 198-99.

with even greater force to the analysis of settlement negotiations because a strong tension exists between the aim of settlement negotiations and the aim of negotiations for the purpose of adopting an alternative fee shifting rule; one seeks to avoid court, the other pushes the parties into the courtroom.<sup>36</sup> Because the aims are contradictory, it is unlikely that parties will attempt simultaneously to settle their dispute and to adopt a wealth-maximizing fee shifting rule. The Coase theorem argument applies only to those cases in which the parties have determined that they will litigate.

The Mause-Shavell analysis of fee shifting leaves several important questions unresolved. The central unresolved issue is this: What determines the parties' estimates of the probability of a plaintiff victory? The process of expectation formation is called into question at two levels. At the settlement level, the comparison of the incentives generated by the British and American rules in the Mause-Shavell analysis implicitly assumes that the parties' probability estimates are the same under the two fee shifting rules. If the fee shifting rule affects expectations regarding the trial outcome, however, this assumption would be inappropriate. The process of expectation formation is also called into question in the analysis of the frequency with which suit is brought under the alternative fee shifting mechanisms. The analysis reveals that suit is more likely under the British rule than under the American rule if the plaintiff's estimate of the probability of victory exceeds the defendant's share of the total cost of litigation. But how is the plaintiff's estimate of the probability of victory determined? It is impossible to say whether suit or settlement is more likely under either rule without answering these questions, and the Mause-Shavell analysis fails to provide an answer.

## 2. The Rational Expectations-Asymmetric Information Model

This subpart presents a model of litigation that explicitly takes into account the formation of expectations regarding trial outcome.<sup>37</sup> In this model, the plaintiff's estimate of the probability of victory is determined either by the equilibrium frequency with which injurers violate

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36. An inherent tension exists between the types of agreements or provisions being negotiated. Spier and Nalebuff have argued that contractual incompleteness results because certain requests may reveal the asker's "type." See, for example, Nalebuff, 18 *Rand J. Econ.* at 199. This Article argues that contractual incompleteness may result because provision A is inconsistent with provision B, and any party who attempts to carry on bargaining about A and B simultaneously will risk signaling a lack of real interest in one of the provisions.

37. For a more detailed and technically oriented presentation of the model, see Hylton, 22 *J. Legal Stud.* at 455 (cited in note 5). This Article extends the analysis in that paper by carrying out a wider variety of simulations of the model.

the legal standard<sup>38</sup> or by private information held by the plaintiff regarding the defendant's compliance with the legal standard. Similarly, the defendant's estimate of the probability of victory is determined either by the equilibrium frequency of violations or by private information held by the defendant concerning his compliance with the legal standard. In this model, a comparison of the American and British rules requires a comparison of the equilibrium compliance rates under the two regimes. The model also allows for the possibility of legal error.

*a. Assumptions*

Let  $W$  represent the probability, given an injury, that the injurer did not comply with the relevant legal standard. In the area of negligence law,  $W$  would represent the probability that the defendant was negligent, given an accident causing injury. In antitrust,  $W$  would represent the probability that the defendant violated the Sherman Act. Let  $Q_1$  represent the probability of type one error—that is, that the court erroneously fails to hold a defendant liable. Let  $Q_2$  represent the probability of type two error—that is, that the court erroneously holds a defendant liable. The model assumes that  $Q_1$  and  $Q_2$  are public information. These assumptions generate four "information regimes":

*Plaintiff uninformed, defendant informed.* In this regime the plaintiff estimates the probability of a verdict in his favor by averaging over the populations of innocent and guilty injurers (where "innocence" and "guilt" indicate whether or not the defendant has violated the applicable legal standard). In the case of an innocent injurer, the probability of a verdict for the plaintiff is simply the probability of type two error. For a guilty injurer, the probability of a verdict for the plaintiff is simply one minus the likelihood of type one error. Thus, the rational estimate for the uninformed plaintiff of the likelihood of a verdict in his favor is  $P_p = W(1 - Q_1) + (1 - W)Q_2$ . Since the defendant is informed, his estimate of the probability of a verdict in favor of the plaintiff is one minus the probability of type one error if the defendant is guilty (that is,  $P_d = 1 - Q_1$  if the defendant is guilty of violating the

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38. In the terms of economics literature, the plaintiff makes a rational expectations estimate of the probability of victory. Rational expectations in its mildest form assumes that subjective frequency expectations are equal to objective frequencies in equilibrium. A stronger form assumes that agents are familiar with the process that generates observed frequencies and that they use that information in making forecasts. The theory has been applied largely in macroeconomics literature, starting with John F. Muth, *Rational Expectations and the Theory of Price Movements*, 29 *Econometrica* 315 (1961).

For a model of litigation in which plaintiffs make rational expectations estimates of the probability of victory, see I.P.L. Png, *Strategic Behavior in Suit, Settlement, and Trial*, 14 *Bell J. Econ.* 539, 540-44 (1983); I.P.L. Png, *Litigation, Liability, and Incentives for Care*, 34 *J. Pub. Econ.* 61 (1987).

legal standard). If the defendant is innocent, his estimate of the likelihood of a verdict for the plaintiff is simply the probability of type two error (that is,  $P_d = Q_2$  if the defendant is innocent).

*Plaintiff informed, defendant uninformed.* The plaintiff's estimate of the probability of a verdict in his favor is  $P_p = 1 - Q_1$  if the defendant violated the legal standard and  $P_d = Q_2$  if the defendant did not violate the legal standard. The defendant's estimate of the probability of a verdict in his favor is  $P_d = W(1 - Q_1) + (1 - W)Q_2$ , whether or not he violated the legal standard.

*Both parties uninformed.* The plaintiff's estimate of the probability of a verdict in his favor is  $P_p = W(1 - Q_1) + (1 - W)Q_2$ ; the defendant's estimate of the probability of a verdict in the plaintiff's favor is the same.

*Both parties informed.* The plaintiff's estimate of the probability of a verdict in his favor is  $P_p = 1 - Q_1$  if the defendant violated the legal standard, and the defendant's estimate is the same in this circumstance. Similarly, if the defendant did not violate the legal standard, then both the plaintiff and the defendant will estimate that the probability of a verdict in favor of the plaintiff is  $Q_2$ .

This Article extends the Mause-Shavell analysis by examining the incentive to settle under alternative fee rules within the first three information regimes.<sup>39</sup>

#### *b. The Incentive to Settle*

The settlement-versus-litigation question arises only if the plaintiff is willing to bring suit; therefore, assume in this subpart that the plaintiff has an incentive to bring suit. The previous subpart introduced the three informational regimes; this subpart will further discuss the differences between the regimes because the differences have important implications for the settlement problem.

Recall that under the American rule, the parties will choose to litigate rather than settle if, given suit, the difference between the perceived stakes exceeds the total cost of litigation.<sup>40</sup> The information regime assumptions become important at this stage. Suppose the defendant is the informed party and knows that he is guilty. Then the

39. This Article does not examine the regime in which both parties are informed because it is uninteresting. The analysis in the preceding subpart leads to the conclusion that all cases will settle in a regime in which both parties are informed. Further, because the parties are assumed to have all relevant information before trial occurs, there is no reason to think that differences in estimates will result from information transmitted during settlement negotiations. For further discussion of this issue, see notes 54-56 and accompanying text.

40. More precisely, the parties will choose to litigate rather than settle if  $(P_p^A - P_d^A)J > (C_p + C_d)$ . See text accompanying note 29.



difference between the perceived stakes is negative;<sup>41</sup> thus, the parties have an incentive to settle. Suppose the plaintiff is the informed party and knows that the defendant is not guilty. Because the difference between the perceived stakes again is negative,<sup>42</sup> the parties have an incentive to settle. Thus, if the defendant knows that he is guilty, he will always have an incentive to settle the dispute. Similarly, if plaintiffs are informed, then all plaintiffs facing innocent defendants will seek to settle their disputes.

It follows from the foregoing analysis that information regimes determine settlement incentives. These incentives are examined in each information regime below.

*Defendant informed, plaintiff uninformed.* Recall that if the defendant is the informed party, he will always seek to settle the dispute when he is guilty. If guilty defendants always settle, however, then litigation would involve only innocent defendants. Such a situation could not be an equilibrium because innocent defendants would effectively reveal their status by refusing settlement demands. Once informed of the status of innocent defendants, plaintiffs would lower their settlement demands accordingly and settlement would occur. Litigation would never occur.<sup>43</sup>

So why does litigation occur? Literature has identified strategic behavior as the reason.<sup>44</sup> One form of strategic behavior is a defendant's desire to litigate in order to establish a reputation or to change the legal rule in a desired direction.<sup>45</sup> If this were the only type of strategic behavior, however, the puzzle would remain because litigants who wish to change the legal rule or establish reputations as contestants are often identifiable at an early stage. A second type of strategic behavior results from efforts to obtain a larger share of the settlement surplus.<sup>46</sup> Settle-

41. To see this, note that  $P_p^A - P_d^A = W(1 - Q_1) + (1 - W)Q_2 - (1 - Q_1) < 0$ .

42. Note that if the defendant is informed and is not guilty, then  $(P_p^A - P_d^A)J = (Q_2 - P_d^A)J < 0$ .

43. This process of full information disclosure is analogous to another indirect disclosure process considered in literature on the economics of information. Suppose a seller has information on the quality of a product that the buyer is unable to observe but easily can verify. The market then will generate full disclosure. All sellers with favorable information will disclose, leaving only those with unfavorable information refusing to disclose. Buyers will then assume the worst of non-disclosing sellers, and prices will fully reflect quality. See Paul R. Milgrom, *Good News and Bad News: Representation Theorems and Applications*, 12 Bell J. Econ. 380, 387-90 (1981).

44. See Robert Cooter, Stephen Marks, and Robert Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. Legal Stud. 225 (1982); Png, 14 Bell J. Econ. at 539 (cited in note 38); Png, 34 J. Pub. Econ. at 61 (cited in note 38); Kathryn E. Spier, *The Dynamics of Pretrial Negotiation*, 59 Rev. Econ. Stud. 93 (1992); Hylton, 22 J. Legal Stud. at 187 (cited in note 29).

45. See Paul H. Rubin, *Common Law and Statute Law*, 11 J. Legal Stud. 205 (1982).

46. Cooter, Marks, and Mnookin emphasized this type of strategic behavior. See Cooter, Marks, and Mnookin, 11 J. Legal Stud. at 225 (cited in note 44).

ment cannot occur in some cases because both parties adopt hard bargaining strategies in order to maximize their share of the savings from settling rather than litigating the dispute. This explanation of litigation is problematic: if parties often failed to settle because they could not agree on a division of the settlement surplus, presumably "split the difference" norms would develop that would allow parties to avoid litigation.<sup>47</sup>

A third type of strategic behavior—signaling behavior—offers hope of explaining ordinary litigation.<sup>48</sup> Suppose only innocent defendants refused to accept plaintiffs' "reasonable" settlement demands (that is, those demands within the settlement zone for guilty defendants). Guilty defendants would then have an incentive to reject settlement demands within the same range in order to fool plaintiffs into thinking they are innocent. If, on the other hand, all guilty defendants tried to signal innocence by rejecting settlement demands, then rejection would lose its value as a signal of innocence. In equilibrium one should expect some fraction of guilty defendants to reject settlement demands,<sup>49</sup> and in order for the signal to retain its value one should expect this fraction to be relatively small. Given strategic rejections on the part of guilty defendants, plaintiffs will be reluctant to lower their settlement demands to a range that would allow all innocent defendants to accept plaintiffs' demands. In the end, litigation may result.

This is not the end of the litigation puzzle because at this stage this Article has done nothing more than use the signaling argument to justify litigation between uninformed plaintiffs and innocent defendants. The question that remains is whether guilty defendants will ever litigate. The question is troubling because at the end of settlement negoti-

47. For example, the plaintiff and the defendant may quickly agree to split the settlement surplus in half. The theoretical foundation for such a resolution is the Nash bargaining solution. See John Nash, *The Bargaining Problem*, 18 *Econometrica* 155 (1950). For an application of the Nash bargaining solution to the settlement problem, see Robert Cooter, *Towards a Market in Unmatured Tort Claims*, 75 *Va. L. Rev.* 383, 410-11 (1989).

48. See Png, 34 *J. Pub. Econ.* at 61 (cited in note 38); Spier, 59 *Rev. Econ. Stud.* at 93 (cited in note 44); Hylton, 22 *J. Legal Stud.* at 312 (cited in note 29).

49. Using game theory terminology, the equilibrium condition is this: The two "pure" strategies—acceptance and rejection—must have the same expected payoff to a guilty defendant. If rejection loses its value as a signal of innocence, guilty defendants will not have an incentive to reject. If, on the other hand, no guilty defendants reject, the signaling value of rejection should be very strong, which would lead some guilty defendants to start rejecting demands. The equilibrium proportion of guilty defendants who reject settlement demands is that proportion which equates the expected payoff from rejection with the expected payoff from acceptance of the plaintiff's settlement demand. For a non-technical elaboration of this argument, see Hylton, 22 *J. Legal Stud.* at 195 (cited in note 29). For more technical elaborations, see Png, 14 *Bell J. Econ.* at 539 (cited in note 38), and Spier, 59 *Rev. Econ. Stud.* at 93 (cited in note 44).

ations, guilty defendants should prefer to settle rather than face a judgment.

Two reasons can be offered for litigation by guilty defendants. First, some plaintiffs break off settlement negotiations early and pursue a strategy of litigation, even though the trial date has not arrived. Second, because of the possibility of appeal, a defendant may not perceive the end period of settlement negotiations during a trial as the real end period. If the defendant expects to appeal and to have the judgment reduced, he may have an incentive to reject settlement demands even in the final period of negotiations at the trial court level. The upshot of this analysis is that because of strategic signaling behavior, litigation will occur, some of it involving guilty defendants.

Calculating the proportions of innocent and guilty defendants in equilibrium is a complicated task. This Article aims only to compare cost allocation regimes in terms of the amount of litigation produced by each regime, not to describe in detail the equilibrium under each regime. In making this comparison, the Article adopts the simplifying assumption that the frequency of litigation in each cost allocation regime is directly proportional to the number of disputes in which the settlement zone is empty. Given this assumption, the probability of litigation is equal to the probability that the parties choose to litigate (that is, that the settlement zone is empty) multiplied by the probability that the defendant is innocent. Under the American rule, the probability of litigation, given an injury, is

$$\text{Prob}[(P_p^A - P_d)J > (C_p + C_d)](1 - W^A),$$

where  $W^A$  is the probability of non-compliance under the American rule. Under the British rule the probability of litigation, given an injury, is

$$\text{Prob}[(P_p^B - P_d)J > (1 - P_p^B + P_d)(C_p + C_d)](1 - W^B),$$

where  $W^B$  is the probability of non-compliance under the British rule. Similar formulae can be used to compare the settlement probability under the American rule with the settlement probability under the Proplaintiff and Prodefendant rules.<sup>50</sup>

50. Under the Proplaintiff rule, the probability of litigation, given an injury, is

$$\text{Prob}[(P_p^P - P_d)J > (1 - P_p^P + P_d)C_p + C_d](1 - W^P),$$

where  $W^P$  is the probability of non-compliance under the Proplaintiff rule. Under the Prodefendant rule, the probability of litigation, given an injury is

$$\text{Prob}[(P_p^D - P_d)J > (1 - P_p^D + P_d)C_d + C_p](1 - W^D),$$

where  $W^D$  is the probability of non-compliance under the Prodefendant rule.

*Plaintiff informed, defendant uninformed.* The litigation puzzle discussed above also occurs in the case in which the plaintiff is the informed party. Recall that when the plaintiff is informed and the defendant is uninformed, all disputes involving innocent defendants should settle because no rational plaintiff will have an incentive to litigate against a defendant the plaintiff knows to be innocent. Again, this proposition suggests that litigation will not occur in equilibrium. If litigation involves only guilty defendants, plaintiffs will adjust their settlement demands to reflect this fact. In equilibrium all disputes would settle.

Again, strategic signaling behavior produces litigation. It is the signaling behavior of the plaintiff, however, that leads to litigation in this scenario. The plaintiff, knowing the defendant is innocent, will make unreasonably high settlement demands in order to fool the innocent defendant into settling on the same terms as a guilty defendant. Given that the defendant is uninformed, an outcome in which only plaintiffs who know that they are facing a guilty defendant make high settlement demands cannot be an equilibrium because a plaintiff facing an innocent defendant will then have an incentive to make a high settlement demand. For reasons discussed in the examination of the informed defendant and uninformed plaintiff case, the equilibrium should be one in which a small proportion of the plaintiffs who litigate do so against innocent defendants.

Again, this Article makes the simplifying assumption that the frequency of litigated cases is directly proportional to the number of disputes in which the settlement zone is empty and the defendant is guilty. Given this assumption, the probability of litigation under the American rule, assuming an injury, is given by

$$\text{Prob}[(P_p^A - P_d)J > (C_p + C_d)]W^A,$$

where  $W^A$  represents the probability of non-compliance under the American rule. Under the British rule the probability of litigation, given an injury, is

$$\text{Prob}[(P_p^B - P_d)J > (1 - P_p^B + P_d)(C_p + C_d)]W^B,$$

where  $W^B$  represents the probability of non-compliance under the British rule.

*Both parties uninformed.* When both parties are uninformed and have access to the same information, their rational expectations estimates of the probability of a verdict in the plaintiff's favor should be the same. It follows that they will never litigate because the difference in the parties' estimates of the expected judgment for the plaintiff is zero.

This information regime also should be analyzed under a different theory of litigation, one that draws on Cooter, Marks, and Mnookin.<sup>51</sup> They hypothesized that litigation has two causes: (1) random or idiosyncratic errors in estimation that produce differences in the parties' expectations of awards, and (2) strategic behavior with respect to the settlement stakes (or the surplus from settlement).<sup>52</sup> In the information regimes examined earlier in this Part, litigation resulted because the settlement zone was empty; the settlement zone in turn was empty because of informational asymmetry. Parties were assumed to estimate rationally the likelihood of the plaintiff winning so that informational asymmetry provided the only possible source of differences in expectations.<sup>53</sup>

Cooter, Marks, and Mnookin assumed that parties make rational expectations estimates of the likelihood of the plaintiff winning and that both parties generally have access to the same information in forming their expectations.<sup>54</sup> Parties generally form expectations on the basis of observable traits; certain unobservable traits exist, however, which lead parties to adopt tactics that deviate from expected strategies. Thus, although expectations are accurate with respect to the average or typical party, they might be inaccurate with respect to any individual.<sup>55</sup> These random deviations between expected and actual behavioral patterns produce litigation of two types. First, the random deviations yield cases in which the settlement zone is empty. Second, the random deviations lead to litigation even when the settlement zone is not empty because parties make strategic efforts to grab as large a share of the settlement surplus as possible. Because parties sometimes incorrectly predict their opponents' behavior, litigation results.<sup>56</sup>

This model makes no attempt to allow for strategic behavior in splitting the settlement surplus; it allows for only one component of the Cooter, Marks, and Mnookin model: random deviations between expectations and actual status that result in instances in which the settlement zone is empty. To formalize this approach, this model assumes that before an injury occurs, the parties have the same expectations of

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51. Cooter, Marks, and Mnookin, 11 J. Legal Stud. at 225 (cited in note 44).

52. *Id.* at 229-32.

53. It should be noted that this proposition is quite different from the assumptions of the earlier literature in this area, which took the view that litigation results from *excessive* optimism on the part of plaintiffs and defendants. See Richard A. Posner, *Economic Analysis of Law* 435-38 (Little, Brown, 2d ed. 1977); Shavell, 11 J. Legal Stud. at 55 (cited in note 26). The model presented in this Article nowhere assumes excessive optimism, but rather assumes that all expectations are rational.

54. Cooter, Marks, and Mnookin, 11 J. Legal Stud. at 231-32 (cited in note 44).

55. *Id.*

56. *Id.* at 246.

the likelihood of the plaintiff winning if an injury followed by a trial should occur. The model further assumes that information revealed after the injury leads to random differences in expectations. The model therefore introduces an error term  $\epsilon$  that represents the difference between the parties' estimates of the probability of a verdict in favor of the plaintiff. The Appendix provides a detailed explanation of the assumptions underlying this model.

### III. LITIGATION MODEL SIMULATION RESULTS

The Rational Expectations-Asymmetric Information model assumes that the relevant legal standard is negligence. The aim of the exercise is to compute the probability of non-compliance (the proportion of injurers who fail to comply with the legal standard) and the probability of litigation under each of the four fee shifting rules considered. In interpreting the results, one should think of the probability of non-compliance as analogous to an equilibrium price in a market model. Its equilibrium value is the level at which plaintiffs' expectations of success are consistent with the frequency of non-compliance in the population of potential injurers after discounting for error in the courts. Details of the model are provided in the Appendix; its most basic features are described below.

The model assumes that an injurer can reduce the probability of an accident occurring by taking care and that taking care is costly. Let the cost to a potential injurer of taking care be  $x$ . If the potential injurer takes care, the probability of an injury to a victim is  $q$ . If the potential injurer does not exercise care, the probability of an injury is  $p$ , and  $p > q$ . Let  $v$  be the loss a victim suffers if an injury occurs. According to the Hand formula, the injurer has acted negligently if he fails to take care, an accident occurs, and the condition  $(p-q)v > x$  holds. Further, the model assumes that litigation is costly and that courts occasionally err in determining negligence. The simulations assume that victims and injurers act rationally. Thus, victims bring suit only if the expected cost of litigating is less than the expected award; potential injurers take care only if the expected liability (the sum of liability to victims and expected litigation costs) is greater than the cost of taking care. In equilibrium, the probability of non-compliance is equal to the rate at which injurers fail to comply with the due care standard. The equations describing these incentive conditions are presented in the Appendix.

#### A. Non-Compliance Rates

The simulations presented in Figures 1, 2, and 3 show the non-compliance rates under alternative informational regimes generated by

simulating the negligence litigation model. The simulations used several combinations of numerical values for the accident probabilities,  $p$  and  $q$ . The simulations shown in the Figures assume that  $p = .75$  and  $q = .25$ .<sup>57</sup>

*Information Regime 1: Defendant informed, plaintiff uninformed.* The results are presented in Figure 1. Non-compliance rates rise with litigation costs under each of the fee rules in Figure 1 because the effect of litigation costs on the probability that suit will be brought is the dominant influence on equilibrium compliance in this model.<sup>58</sup>

*Information Regime 2: Neither party informed.* Figure 2 presents results for the case in which neither party has an informational advantage. The results are similar to those in the case in which the plaintiff has the informational advantage. The Proplaintiff rule results in the highest compliance rates, the Prodefendant rule the lowest. The American and British rules yield roughly equal compliance rates, with the British slightly outperforming the American rule at high litigation cost levels and the American outperforming the British at low litigation cost levels.

*Information Regime 3: Plaintiff informed, defendant uninformed.* The general ranking of the cost allocation regimes in terms of their influence on incentives to comply is the same as the ranking in the previous two information regimes. Figure 3 presents several novel features: the non-compliance rates hit zero fairly quickly under the Proplaintiff rule, and they fall as litigation costs rise under the British rule. This fact results in a large divergence in compliance rates between the British and American rules at high cost levels.<sup>59</sup>

The zero non-compliance rates under the Proplaintiff rule are easily explained. The plaintiff has the informational advantage, and fees are shifted exclusively in his favor under this rule. Thus, the plaintiff

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57. The results based on other values of  $p$  and  $q$  were basically the same. For discussion of these results, see Hylton, 22 J. Legal Stud. at 465 (cited in note 5).

58. For further discussion of the American and British rules, see *id.* at 469.

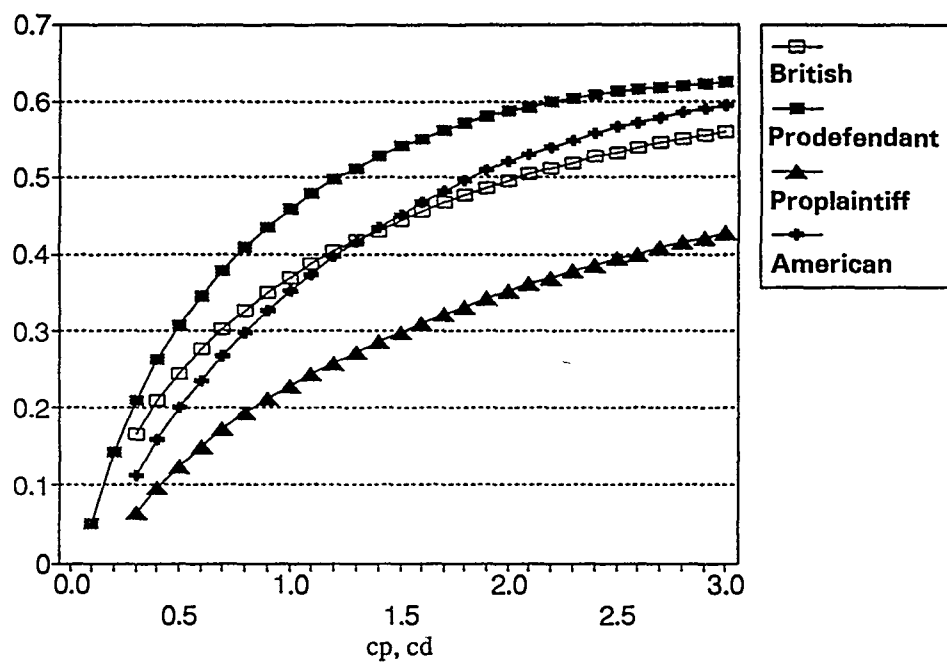
59. Since Figure 3 differs from the previous two figures, a more detailed explanation of the results is necessary. Two influences explain the curves in Figure 3: one is the informational advantage enjoyed by plaintiffs; the other is the costliness of litigation. At low litigation cost levels, the informational advantage effect outweighs all other influences. Guilty defendants face a high probability of suit from injured victims as a result and therefore have strong incentives to comply. The incentives increase as the costliness of litigation increases because, in expectation, defendants bear some portion of the costs under each cost allocation rule. At some point, as the diagram reveals, the costliness of litigation becomes such a burden on plaintiffs that they bring suits less frequently. Thus, under the American rule, at a certain point the cost of litigation begins to burden plaintiffs to such a degree that the rate at which they sue falls. As a result, defendants' expected total liability decreases commensurately. At this point, the rate of compliance also starts to fall (that is, the non-compliance rate increases) and continues to fall as the costliness of suit increases.

has an unusually strong incentive to sue defendants who are guilty of violating the legal standard. Overcompliance results among potential injurers for cost levels above half the average injury award.

The British rule performs better in terms of compliance than does the American rule for the same reason as that given for the performance of the Proplaintiff rule. Because the plaintiff has the informational advantage, the British rule provides very strong incentives to sue guilty defendants, and the incentives strengthen as the cost levels increase. Because plaintiffs face the risk of being forced to pay the litigation costs of defendants, the incentive to sue is not as strong as under the Proplaintiff rule. For this reason the British rule provides a milder influence on incentives to comply than does the Proplaintiff rule.



Figure 1



## Notes to Figures 1, 2, and 3

1. The horizontal axis measures a plaintiff's or defendant's cost of litigating as a multiple of the average loss from injury.
2. The vertical axis measures the probability of non-compliance.

Figure 2

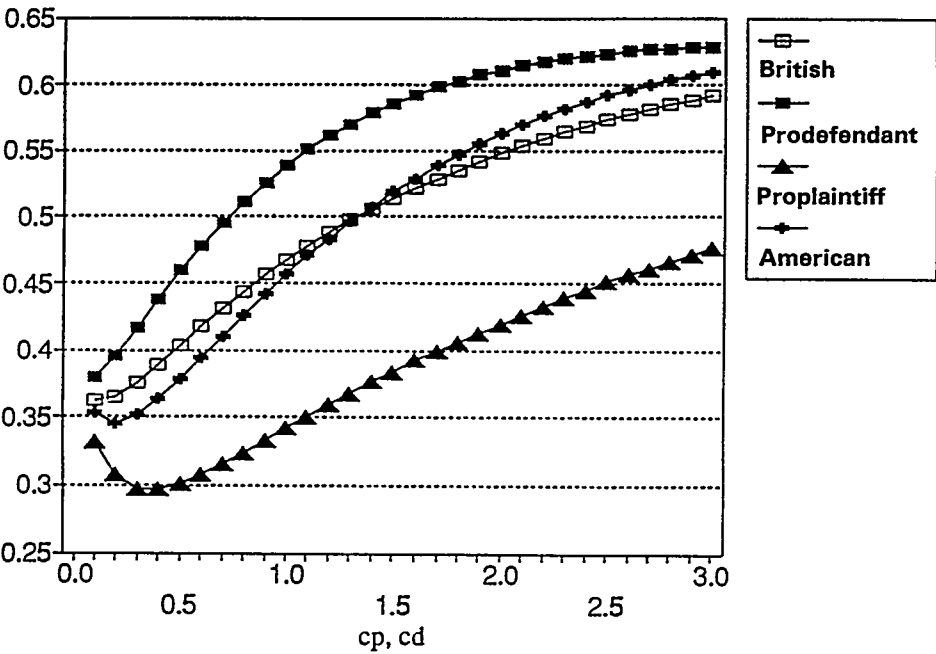
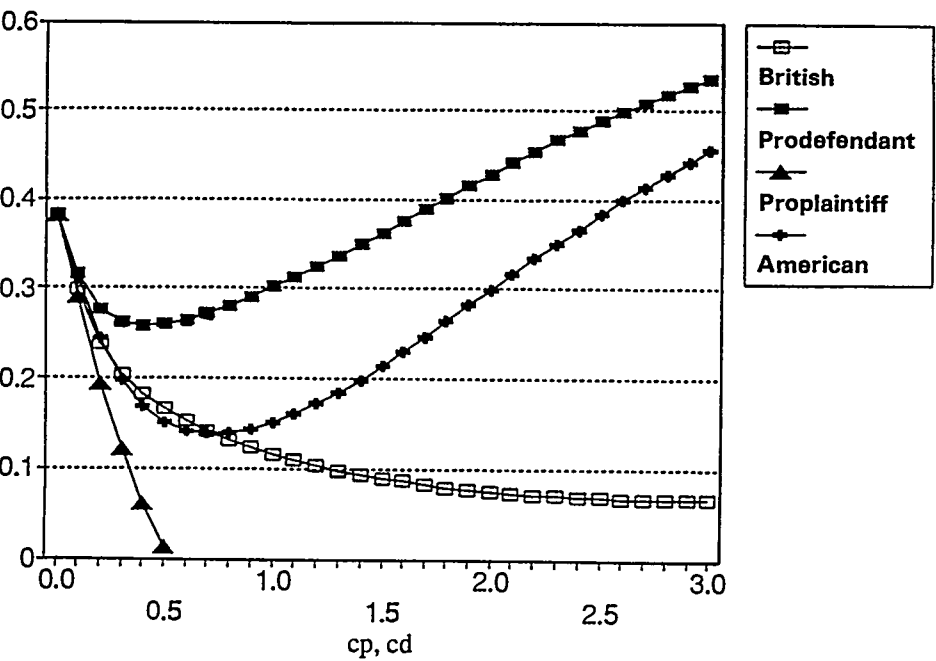


Figure 3



### B. Frequency of Litigation

Using the equilibrium non-compliance rates, the simulation calculated the probability of litigation under the litigation cost allocation rules. This subpart presents the results under each information regime.

*Information Regime 1: Defendant informed, plaintiff uninformed.* The results are presented in Figure 4. The Prodefendant and British rules are fairly similar, with the Prodefendant rule generating the most litigation at low litigation cost levels and the British rule generating the most at high cost levels (that is, at cost levels above one and one-half times the average award). The Proplaintiff rule generates the least litigation at all cost levels. Thus, the cost allocation rules may be ranked as follows (from the rule under which settlement is most likely to the one under which it is least likely): Proplaintiff, American, Prodefendant, British. This ranking should be compared to the ranking derived by Steven Shavell, who has presented the only previous ranking of fee shifting regimes. Examining the effects of cost shifting on the perceived stakes, Shavell demonstrated that the litigation cost systems can be ranked in the following order (from the rule under which settlement is most likely to the one under which it is least likely): (1) American, (2) Prodefendant and Proplaintiff, (3) British.<sup>60</sup>

*Information Regime 2: Neither party informed.* Figure 5 presents the probability of litigation under the regime in which neither party has an informational advantage. The British rule generates the most litigation and the American rule the least. The Prodefendant and Proplaintiff rules generate the same level of litigation. Because parties' estimates of the likelihood of a verdict in favor of the plaintiff are roughly equal under this informational regime, the results essentially confirm those of Steven Shavell.<sup>61</sup>

*Information Regime 3: Plaintiff informed, defendant uninformed.* The results for the regime in which the plaintiff has the informational advantage are shown in Figure 6. The following ranking emerges (from least to most litigious): Proplaintiff, American, Prodefendant, British. Interestingly, the rate of litigation under the Proplaintiff rule falls to zero at the point at which cost is equal to one-half the average damage award. The explanation is as follows: No guilty defendants are found in this regime at cost levels above one-half<sup>62</sup> because defendants are overcomplying at this range of litigation cost levels. Thus, both plaintiffs who know the defendant's true status and defendants who must

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60. Shavell, 11 J. Legal Stud. at 55 (cited in note 26). It should be noted that Shavell's ranking is based on the assumption that the defendant's litigation cost is equal to the plaintiff's.

61. For Shavell's ranking, see text accompanying note 60.

62. See Figure 3.

estimate the probability of their innocence will be aware in equilibrium that the probability of a verdict in favor of the plaintiff is equal to the rate of erroneous verdicts for the plaintiff. Because their expectations of the trial outcome will be the same, they will settle.

Figure 4

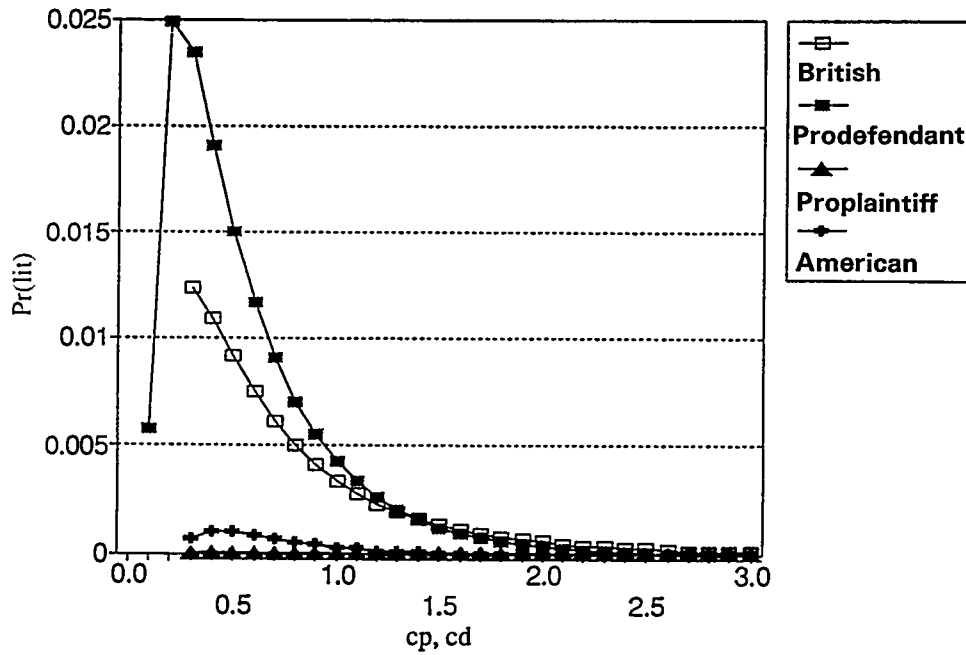


Figure 5

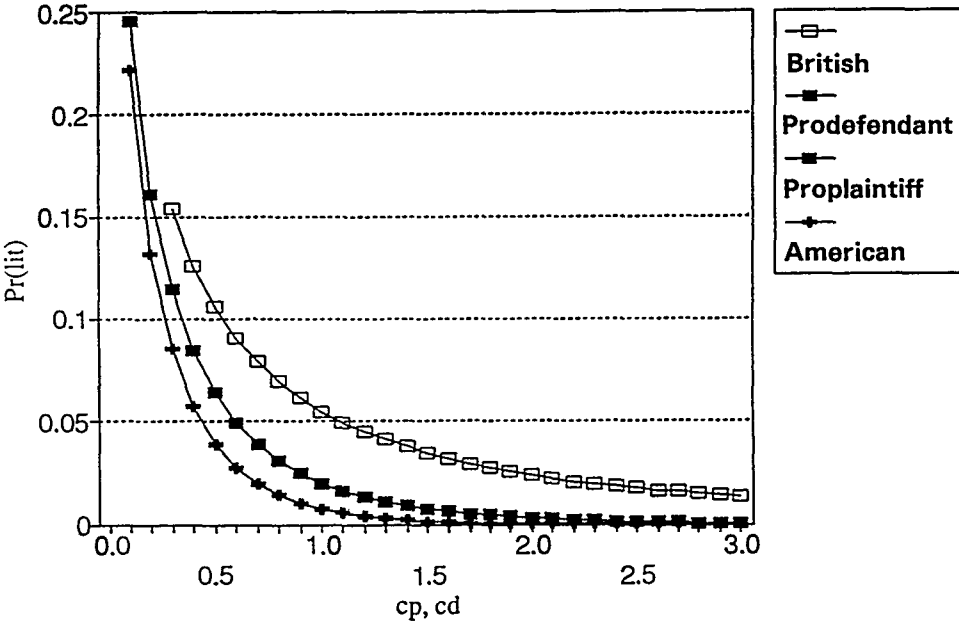
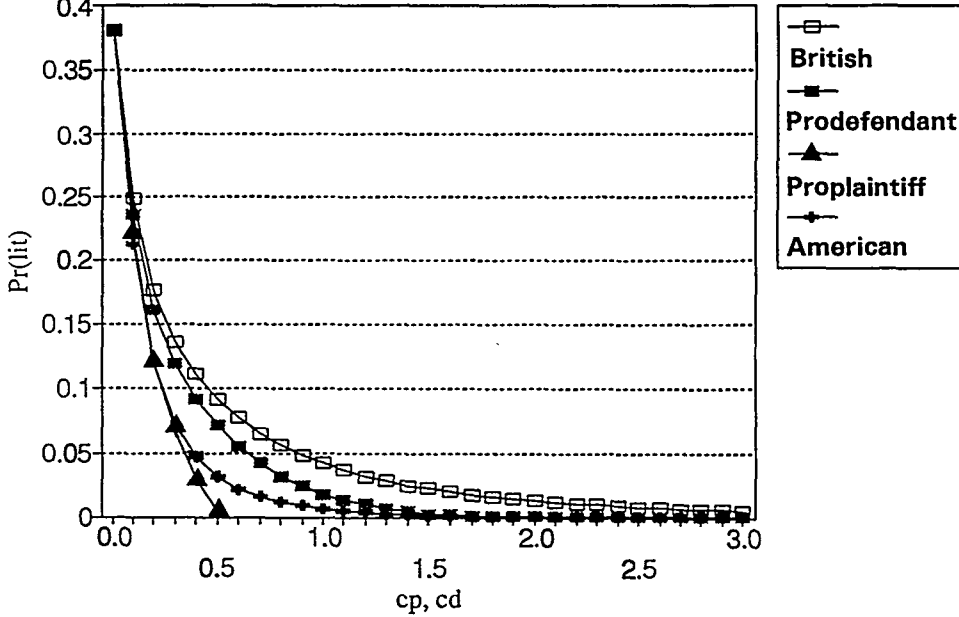


Figure 6



### C. General Conclusions

The simulations lead to the general conclusion that the Proplaintiff rule provides the greatest incentives for compliance with the legal standard; this is because the Proplaintiff rule provides victims the greatest degree of access to the courts. For the same reason the Prodefendant rule provides the weakest incentives for potential injurers to comply. The American and British rules generally are close in terms of their influence on compliance incentives except in the regime in which the plaintiff has the informational advantage. In that regime the British rule provides significantly stronger compliance incentives than does the American rule when the cost of litigating is high.

In spite of its tendency to encourage suit, the results suggest that the Proplaintiff rule generates the least litigation. In two of the three informational regimes examined, the Proplaintiff rule generated uniformly lower litigation probabilities than did the other cost allocation rules. The conclusion that the Proplaintiff rule tends to generate the least litigation may seem counterintuitive because the Proplaintiff rule goes further than the other rules in encouraging victims to bring suit. Certainly the common intuition is that pro-plaintiff fee shifting generates litigation. This intuitive proposition would be valid under a strict liability system in which the probability of compliance is not an issue. The proposition is incorrect, however, when compliance with a standard of conduct is the issue that determines liability. In this situation the Proplaintiff rule encourages both suit and settlement. The rule encourages settlement because low non-compliance rates result in low predicted probabilities of success, which in turn reduce the settlement gap between plaintiffs and defendants.

### D. Implications

#### 1. Economic Efficiency

This Article has not proven that pro-plaintiff fee shifting is economically efficient; it has only shown that, within the confines of the model examined, pro-plaintiff fee shifting simultaneously promotes compliance and settlement more effectively than does any other fee shifting rule. One might determine the efficiency of pro-plaintiff fee shifting by examining whether it minimizes the sum of the costs of injury, injury avoidance, and litigation.<sup>63</sup> The analysis would necessarily be incomplete, however, because an infinite number of aspects of social

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63. The text describes the operational efficiency norm applied to tort law in Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* 28-29 (Yale U., 1970).

welfare exist that an efficiency analysis could take into account. For example, the risk aversion of litigants may influence the optimal fee shifting rule.<sup>64</sup>

Although this Article has made no effort to answer the efficiency question, one may draw some implications from the simulation results. Assume that efficiency requires minimization of the costs of injury, injury avoidance, and litigation; assume further that parties are risk neutral. The results in which the non-compliance frequency remains positive for all litigation cost levels,<sup>65</sup> and in which the Proplaintiff rule minimizes the probability of non-compliance and the probability of litigation, suggest that the Proplaintiff rule is economically efficient. The reason is as follows: If the non-compliance rate is positive, then it is socially desirable that more potential injurers take care.<sup>66</sup> Pro-plaintiff fee shifting is superior in this regard to rules that lead to less caretaking. If pro-plaintiff fee shifting leads to increased caretaking and also minimizes litigation, it is efficient. This analysis implies that pro-plaintiff fee shifting is efficient in information regimes in which the plaintiff is uninformed since the probability of non-compliance remains positive over all litigation cost levels in the results for these regimes. In the regime in which the plaintiff is the informed party, it is not clear that pro-plaintiff fee shifting is economically efficient because the Proplaintiff rule leads to overcompliance on the part of potential injurers, which implies that it may be socially desirable to have fewer potential injurers take care. Without parameter values that could be used to evaluate tradeoffs between deterrence benefits and litigation cost increases, it is impossible to determine whether pro-plaintiff fee shifting is economically efficient.

A somewhat less tentative conclusion suggested by the simulation results is that pro-plaintiff fee shifting is likely to produce the benefits

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64. See John J. Donohue III, *The Effects of Fee Shifting on the Settlement Rate: Theoretical Observations on Costs, Conflicts, and Contingency Fees*, 54 L. & Contemp. Probs. 195, 202-09 (1991). Consideration of risk aversion generally will lend support to the American rule because the alternative rules make litigation riskier. Under the efficiency norm described in the text, risk aversion in litigation could be considered one of the "costs" of litigation.

Risk aversion in litigation is simply one of a potentially infinite number of costs that could (or should) be considered in an efficiency analysis. Under the heading "costs of injury," for example, one could require an efficiency analyst to consider the demoralization that results from the realization that not all injury costs will be compensated.

65. See Figures 1 and 2.

66. Non-compliance in this model means that the defendant fails to take care when the cost of taking care (on the margin) is less than the expected harm to victims from the defendant's failure to take care (on the margin). It follows that compliance is socially desirable. If litigation costs are taken into account, then overcompliance is socially desirable. For a demonstration of this claim, see Keith N. Hylton, *Costly Litigation and Legal Error Under Negligence*, 6 J. L. Econ. & Org. 433 (1990).

demonstrated in this Article in a wide variety of legal regimes. That is, the positive results of pro-plaintiff fee shifting are not limited to negligence litigation because the model of negligence used in this Article is general enough to be applied to other standards of conduct defined by law. Most legal rules are standards of conduct that require the court to weigh specified social costs against specified social benefits before finding a violation. For example, consider the Rule of Reason in antitrust analysis, which generally requires a comparison of the social costs and social benefits of an alleged restraint of trade.<sup>67</sup> If the social costs outweigh the social benefits, the defendant has violated the antitrust laws. It would require only a redefinition of terms used in the model defined in the previous Part to demonstrate the model's applicability to litigation under the Rule of Reason standard in antitrust. Products liability law provides another example of the applicability of the negligence standard used in this model. Although products liability is often described as an area in which liability is strict, the risk utility test applied in defective design cases requires a weighing of the social costs and benefits of redesigning the product.<sup>68</sup> Because courts generally apply balancing tests of some sort in determining liability or legality, the negligence model examined in this Article probably has implications that are valid for many areas in which the legal test is not a negligence test.

## 2. Efficiency Versus Fairness

One of the earliest objections to fee shifting claimed that in view of the uncertainty of litigation it would be "unfair" to force the loser to pay the litigation costs of the prevailing party.<sup>69</sup> The argument never gathered much steam, however; commentators seem to have discarded it after Arthur Goodhart summarily rejected it.<sup>70</sup> The results of the model presented in this Article provide new insights on the fairness argument.

The nub of the fairness critique is that it is possible under a system of pro-plaintiff fee shifting that innocent parties may be forced to pay

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67. For an example, see *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 49-57 (1977) (discussing the tradeoff between promotion of interbrand and intrabrand competition).

68. See, for example, *Halphen v. Johns-Manville Sales Corp.*, 788 F.2d 274 (5th Cir. 1986); *Larsen v. General Motors Corp.*, 391 F.2d 495 (8th Cir. 1968); *Azzarello v. Black Brothers Co., Inc.*, 480 Pa. 547, 391 A.2d 1020 (1978); *Volkswagen of America, Inc. v. Young*, 272 Md. 201, 321 A.2d 737 (1974); W. Page Keeton, et al., *Prosser and Keeton on the Law of Torts* § 99 at 699 & n.30 (West, 5th ed. 1984).

69. See A. G. Sedgwick, *Elements of Damages* 37-38 (Little, Brown, 1896); Linton Satterthwaite, *Increasing Costs to be Paid by Losing Party*, 46 N.J. L. J. 133 (1923).

70. See Arthur Goodhart, *Costs*, 38 Yale L. J. 849, 877 (1929) (claiming that if litigation is "so much a matter of luck . . . it would be cheaper, and certainly less dilatory, to spin a coin").



costs at a surprisingly high rate. To see this, assume that the defendant has the informational advantage in litigation. Then, as the previous Part argued, guilty defendants generally will be willing to settle while innocent defendants will not.<sup>71</sup> The previous Part also argued that in equilibrium a high fraction, though not one hundred percent, of litigating defendants will be innocent. Let  $\alpha$  represent the fraction of innocent defendants who litigate to judgment. Then the fraction of losing defendants (those forced to pay costs) who are innocent is given by

$$\alpha Q_2 / [\alpha Q_2 + (1 - \alpha)(1 - Q_1)].$$

In carrying out the simulations, it was assumed that  $Q_1 = Q_2 = 1/8$ .<sup>72</sup> Assume further that  $\alpha = 9/10$ . Under these assumptions, fifty-six percent of losing defendants are innocent. In the information regime in which defendants have the advantage, the percentage of losing defendants who are innocent will be much higher than in the other information regimes. For example, if one assumes that in the regime in which the plaintiff has the advantage  $\alpha = 1/10$ , then the percentage of losing defendants who are innocent is just below two percent.

To tilt the argument in favor of those who would press the fairness critique, assume further that in most litigation defendants have the informational advantage. Then it is hard to avoid feeling that a system that forces a losing defendant to pay his opponent's legal expenses is unfair when in half of the cases the defendant is innocent.

This Article makes no attempt to assess the importance of the fairness critique; its aim is to provide a rigorous underpinning for the argument. The critique reveals what may be considered an equity-efficiency tradeoff. The simulation results suggest that compliance is enhanced and administrative costs are minimized by shifting fees in favor of prevailing plaintiffs. The gains are bought, however, at the expense of forcing some innocent defendants to pay their opponents' costs. Again, in the absence of a social welfare function it is impossible to determine whether the potential "fairness costs" of the Proplaintiff rule are too small to outweigh its potential benefits.

#### *E. Possible Shortcomings: Rationality, Insurance, and Other Considerations*

Two objections may be raised to the litigation model examined in this Article. First, it incorrectly assumes that all potential injurers act

71. See Part II.B.2.b.

72. Recall that  $Q_1$  is the probability that the court would erroneously fail to hold the defendant liable, and  $Q_2$  is the probability that the court would erroneously hold the defendant liable. The choice of  $1/8$  is based on the brief survey provided in Gordon Tullock, *Trials on Trial: The Pure Theory of Legal Procedure* 31-33 (Columbia U., 1980).

rationally, always weighing costs against benefits when deciding whether to take care. Second, it fails to take into account the influence of insurance on the caretaking incentives of potential injurers. Considering the rationality objection first, one can admit that the rationality assumptions of the model do not accurately describe the behavioral rules adopted or chosen by all potential injurers. Some actors comply with legal standards even in situations in which a pure comparison of expected liability and costs of compliance would lead to non-compliance.<sup>73</sup> Some actors comply with the law largely out of a concern for the reputational consequences of non-compliance.<sup>74</sup> Others comply because of their desire to be a "good" person.<sup>75</sup> In each of these cases the actors may be behaving rationally, in the sense that their behavior is governed by some comparison of costs and benefits. The cost-benefit test governing their behavior is different, however, from the test assumed in the model presented in this Article. For example, the potential injurer who is concerned about reputation may determine his care level by comparing the reputational costs and benefits of taking care, which may lead to a different conclusion than would a rule requiring a comparison of expected liability to victims with the immediate costs of compliance. Too many examples of this kind of compliance exist to assert that the behavioral rules specified in this Article describe all potential injurers. Further, in some cases the potential injurer may choose *not to comply* for rational reasons that are not described by the cost-benefit test assumed in the simulated model.

Even if many potential injurers comply for reasons unrelated to a comparison of expected liability with the cost of care, however, this

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73. See, for example, Tom R. Tyler, *Why People Obey the Law* (Yale U., 1990) (arguing that people are more likely to comply with the law when they perceive the legal system to be fair). Much of the sociological literature has stressed the importance of informal sanctions (for example, family disapproval) in promoting compliance with the law or norms of conduct. See, for example, L.S. Anderson, et al., *Formal and Informal Sanctions: A Comparison of Deterrent Effects*, 25 Soc. Probs. 103 (1977); Steven R. Burkett and Eric L. Jensen, *Conventional Ties, Peer Influence and the Fear of Apprehension: A Study of Adolescent Marijuana Use*, 16 Soc. Q. Bull. 522 (1975); Donna M. Bishop, *Legal and Extralegal Barriers to Delinquency*, 22 Criminology 403 (1984).

74. For an economic analysis of the role of reputation in markets, see Lewis A. Kornhauser, *Reliance, Reputation, and Breach of Contract*, 26 J. L. & Econ. 691 (1983). Kornhauser demonstrates that reputation can serve as a substitute for law under certain conditions by providing incentives for parties to comply with their contracts.

75. See Robert H. Frank, *Passions Within Reason: The Strategic Role of the Emotions* (W.W. Norton & Co., 1988). Robert Frank's work demonstrates that no necessary inconsistency exists between the theory of rationality and the phenomenon of compliance or cooperation in the absence of legal compulsion. A reputation for or perception of trustworthiness is valuable because people prefer to enter into contractual relationships with trustworthy people. It is hard to maintain a reputation for trustworthiness, however, unless one makes a commitment to comply with the law or behave cooperatively even in situations in which short-run self-interest would lead to different conduct.

group is unlikely to represent all potential injurers. Suppose that only a minority of potential injurers are myopically rational in the sense that they base their compliance decisions on a comparison of expected liability with the cost of compliance. The model presented in this Article describes the incentives of these actors, and its results are not diminished in any sense even if myopically rational actors are in the minority. Presumably the actors who comply even when expected liability is less than the cost of compliance would comply under any fee shifting or liability regime. Altering the fee shifting rule cannot affect their behavior. On the other hand, myopically rational actors' behavior can be influenced, and the changes in the behavior of these actors will determine the compliance equilibrium. Thus, the results of the model presented in this Article do not rely on the assumption that all potential tortfeasors decide their care levels by comparing expected liability against the cost of care. If only a subset of potential injurers adopted this approach, the results would be valid.

A second potential shortcoming of the model is its failure to take into account explicitly the insurance relationship. Many potential injurers carry liability insurance and for this reason may not be as sensitive to compliance incentives as the model assumes. If this statement is true, then the only ground for choosing among fee shifting rules is their effect on litigation. It would be appropriate then to follow the approach of earlier literature by assuming that perceived probabilities of victory in litigation are independent of the fee shifting rule in effect.<sup>76</sup>

The notion that insurance dilutes incentives to take care is based in large part on an incomplete view of the insurance market, one which assumes that insurance is largely a risk-spreading mechanism. Many large corporations, however, purchase insurance even when their shareholders are well-diversified through the stock market and the companies themselves are sufficiently diversified with respect to the risk of tort damages that they should not need to purchase insurance for risk-spreading reasons. Insurers play important roles in these cases: they provide information to the insured on the relationship between behavior and accident claims. Further, in bilateral contracting relationships, insurers provide a more credible source of information than does the other party to the contract.<sup>77</sup> For example, a manufacturing and shipping concern may be large enough to bear easily any losses that might occur in the process of shipping and to share this risk within the ship-

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76. Mause, 55 Iowa L. Rev. at 26 (cited in note 22); Shavell, 11 J. Legal Stud. at 55 (cited in note 26); Donohue, 104 Harv. L. Rev. at 1093 (cited in note 30).

77. Göran Skogh, *The Transactions Cost Theory of Insurance: Contracting Impediments and Costs*, 56 J. Risk & Ins. 726, 727-29 (1989).

ping contract. An information problem, however, does exist: will the manufacturer rely on the shipper's assessments of the cause of a loss? When the manufacturer is unwilling to rely on the reports of the party with whom it has contracted, it may be willing to rely on the reports of an insurer.

Little reason exists to assume that insurance completely severs the relationship between incentives and the threat of liability. If only a weak incentive relationship remains, that relationship may be sufficient to justify examining the incentive effects of alternative fee shifting rules. Little evidence exists, however, that the incentive relationship is weak. Insurers use experience rating and several other instruments to provide direct incentives for insured parties to minimize losses.<sup>78</sup> Further, the role of the insurer as a provider of information on risk suggests that the insurance firm may enhance incentives to take care by providing reliable information to insured parties. Since the evidence is incomplete, readers ultimately must decide for themselves the importance of this consideration. In any event, it remains useful to consider the influence of fee shifting in regimes in which compliance incentives are affected.

#### IV. IMPLICATIONS FOR FEE SHIFTING JURISPRUDENCE

This Part examines the implications of the model's results for the Supreme Court's decisions on fee shifting. Subpart A below discusses the general standard that should govern fee awards. Subpart B considers the standard that should govern the determination of types of litigation expenses that may be shifted. Subpart C examines the potential conflict between rules that enhance incentives to comply and rules that enhance incentives to settle disputes. Because considerable areas overlap among the three subparts, the reader should keep in mind that the subject matter divisions are somewhat artificial.

##### A. When Should Fees Be Shifted?

In *Alyeska Pipeline Service Co. v. Wilderness Society*,<sup>79</sup> the Supreme Court denied federal courts the authority to shift fees under the "private attorney general" doctrine.<sup>80</sup> The doctrine, which federal

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78. If the price of insurance is perfectly responsive to the level of risk generated by the insured, the experience rating generally will provide the insured with the same incentives to avoid generating risk that an uninsured party would have. See, for example, Steven Shavell, *Economic Analysis of Accident Law* 203-04 (Harvard U., 1987). On the economics of liability insurance pricing, see Steven Shavell, *On Liability and Insurance*, 13 Bell J. Econ. 120 (1982).

79. 421 U.S. 240 (1975).

80. For the origin of the private attorney general doctrine, see *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. 400, 402-03 (1968). Federal courts adopted reasoning similar to that in

courts had developed in the early 1970s,<sup>81</sup> permits a prevailing plaintiff to recover fees if he "vindicates a right that (1) benefits a large number of people, (2) requires private enforcement, and (3) is of societal importance."<sup>82</sup> Two doctrines do, however, support the exercise of equitable fee shifting powers: the common fund<sup>83</sup> and bad faith doctrines.<sup>84</sup>

Because the model's results suggest that society would benefit from adopting pro-plaintiff fee shifting as a general rule, the results obviously lend support to the theory underlying the private attorney general doctrine. When rights benefit a large number of people, special incentive problems arise. Why should any one victim bring suit when he or she can wait for another victim to bring a suit that establishes the right?<sup>85</sup> Once the right is established, the victim's cost of enforcing the right is presumably smaller. Future defendants will settle more readily, and the result of litigation against guilty defendants who are unwilling to settle will not be uncertain. Of course, if the expected judgment exceeds the cost of litigating, the victim will gain from bringing suit. If, however, the suit establishes a right that benefits future plaintiffs, the victim would gain more by waiting for someone else to sue first. Although not quite a "prisoner's dilemma," one may observe a similar in-

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*Newman* to justify exercising equitable powers to shift fees in civil rights cases in the absence of an applicable fee shifting statute; these courts developed the private attorney general doctrine. See *Evans v. Jeff D.*, 475 U.S. 717, 747 (1986) (Brennan, J., dissenting).

81. *Evans*, 475 U.S. at 747 (Brennan, J., dissenting).

82. Carl Cheng, Note, *Important Rights and the Private Attorney General Doctrine*, 73 Cal. L. Rev. 1929, 1929 (1985).

83. The common fund doctrine, while not explicitly requiring fee shifting, authorizes counsel for "a party preserving or recovering a fund for the benefit of others in addition to himself, to recover his costs, including his attorneys' fees, from the fund or property itself or directly from the other parties enjoying the benefit." *Alyeska Pipeline*, 421 U.S. at 257. See also *Trustees v. Greenough*, 105 U.S. (15 Otto) 527 (1881). See generally John P. Dawson, *Lawyers and Involuntary Clients: Attorney Fees from Funds*, 87 Harv. L. Rev. 1597 (1974). This judicially created exception to the American rule is most often applied in securities and antitrust litigation.

84. Another judicially created exception to the American rule, the bad faith doctrine, authorizes a court to "assess attorneys' fees at a minimum for the 'willful disobedience of a court order' . . . or when the losing party has 'acted in bad faith, vexatiously, wantonly, or for oppressive reasons.'" *Alyeska Pipeline*, 421 U.S. at 258-59 (quoting *Fleischmann Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714, 718 (1967), and *F.D. Rich Co., Inc. v. Indus. Lumber Co., Inc.*, 417 U.S. 116, 129 (1974)). Rule 11 of the Federal Rules of Civil Procedure, which authorizes the assessment of fees against parties or their counsel who merely act unreasonably, has expanded the bad faith doctrine.

85. Of course, the text describes the public goods theory proposed by Kenneth Dayton in 1933. See Dayton, 167 Annals 32 (cited in note 11). One should note that the text is discussing the case in which injuries are shared by many, not one in which a single plaintiff sues a single defendant. The case discussed in the text is governed by class action suits. The point, however, is that the public goods rationale for the class action applies more generally. On the economics of class action litigation, see Donald N. Dewees, J. Robert S. Prichard, and Michael J. Trebilcock, *An Economic Analysis of Cost and Fee Rules for Class Actions*, 10 J. Legal Stud. 155 (1981).

centive structure in this setting.<sup>86</sup> Too few victims will bring suit to establish rights that are uncertain at the moment of injury. Pro-plaintiff fee shifting offers a solution to the incentive problem observed in this setting.<sup>87</sup> Further, the model's results suggest that the litigation costs generated by the private attorney general doctrine would not necessarily be greater than would costs in its absence.

The private attorney general doctrine provided a logical complement to the common fund doctrine.<sup>88</sup> The common fund doctrine governs cases in which the plaintiff's suit preserves or enhances a fund that exists for the benefit of a well-defined class.<sup>89</sup> For example, based on the doctrine, a plaintiff who brings a shareholder derivative suit and prevails may collect his attorney's fees from the corporation's funds.<sup>90</sup> Courts recognized long ago that this doctrine mitigated the disincentive to bring suit that results because the costs of the suit are borne by one party and the benefits shared by many.<sup>91</sup> In order to prevent the com-

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86. Suppose, for example, that the litigation cost to the plaintiff is \$10. Given the uncertain state of the relevant law, the plaintiff's award will either be \$200, which just compensates the plaintiff, or \$0, with a probability of  $\frac{1}{2}$ . The expected award is \$100. If the plaintiff waits for someone else to bring suit and win, the cost falls to \$2, and the expected award increases to \$200. Then, if the plaintiff waits to bring suit, his expected net reward is \$198 if the other victim sues and -\$200 if the other plaintiff does not sue. If the plaintiff brings suit immediately, his expected net award is \$90 whether or not the other plaintiff sues. While not a prisoner's dilemma, an outcome in which every plaintiff brings suit immediately is not in equilibrium. If all victims bring suit immediately, then one victim can gain by delaying until the law has been settled.

87. Note that this benefit is in addition to the benefit provided by reducing litigation costs as an obstacle to potential plaintiffs. Even in the simple negligence model solved in the previous Part, litigation provides something like a public good in full and overcompliance equilibria. The reason is that if no one brought suit, potential defendants would not take care, and full and overcompliance equilibria would be infeasible. For the development of this argument, see Janusz A. Ordover, *Costly Litigation in the Model of Single Activity Accidents*, 7 J. Legal Stud. 243 (1978). See also Keith N. Hylton, *Costly Litigation and Legal Error Under Negligence*, 6 J. L. Econ. & Org. 433 (1990). In the model developed in the previous Part, the reason litigation occurs in full and in overcompliance equilibria is that courts sometimes erroneously find defendants negligent.

If one were to modify the previous Part's model to take into account the private attorney general concerns, one would allow each suit to establish a right that had the effect of lowering the litigation cost for future plaintiffs. In such a model, a "double disincentive" to sue would exist: the cost of litigation itself and the fact that early litigants subsidize later ones. The private attorney general doctrine would lessen the impact of both disincentives.

88. See Cheng, 73 Cal. L. Rev. at 1931 (cited in note 82).

89. The common fund doctrine cannot be invoked when the class of beneficiaries is not discrete and easily ascertainable. On the "well-defined class" requirement, see, for example, *Petition of Hill*, 775 F.2d 1037, 1041-42 (9th Cir. 1985); *Edwards v. Heckler*, 770 F.2d 1496, 1503 (9th Cir. 1985).

90. See, for example, *Barton v. Drummond Co.*, 636 F.2d 978 (5th Cir. 1981); *Reiser v. Del Monte Properties Co.*, 605 F.2d 1135 (9th Cir. 1979); *Ramey v. Cincinnati Enquirer, Inc.*, 508 F.2d 1188 (6th Cir. 1974). For an economic analysis, see John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669 (1986).

91. As the Supreme Court recognized:

mon fund exception from swallowing the American rule, courts developed additional rules limiting the applicability of the doctrine in several ways.<sup>92</sup> The limitations on the common fund doctrine, however, are to some extent arbitrary. The public goods problem that arises in common fund settings also arises in other areas in which litigation generates a benefit that extends beyond the successful plaintiff.<sup>93</sup> The development of the private attorney general doctrine can be understood as an effort to remove arbitrary restrictions on the common fund theory.

In view of the complementarity of the doctrines, it is hard to understand why the Court did not discard the common fund doctrine along with the private attorney general doctrine.<sup>94</sup> As was true of the private attorney general theory, Congress had not explicitly authorized the common fund doctrine.<sup>95</sup> The literal approach taken in *Alyeska* and more recent cases attempts to freeze fee shifting doctrine in its search for statutory authorization. The arbitrariness of this approach is evident when one examines the status of older doctrines such as the common fund and bad faith theories, which never would have been permissible bases for fee shifting if the Court had consistently sought explicit statutory authorization.

The results of the model presented in this Article suggest that the general standard that should govern fee shifting is one that awards fees to the successful plaintiff and taxes fees against the unsuccessful plain-

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It would be very hard on [the complainant] to turn him away without any allowance except the paltry sum which could be taxed under the fee-bill. It would not only be unjust to him, but it would give to the other parties entitled to participate in the benefits of the fund an unfair advantage. He has worked for them as well as for himself; and if he cannot be reimbursed out of the fund itself, they ought to contribute their due proportion of the expenses which he has fairly incurred.

*Trustees v. Greenough*, 105 U.S. (15 Otto) 527, 532 (1881).

92. In addition to the well-defined class requirement, the common fund doctrine cannot necessarily be invoked when the fund or benefit existed prior to litigation that merely clarified the rights of the parties. See *Feick v. Fleener*, 653 F.2d 69, 77-78 (2d Cir. 1981). Also, the doctrine ordinarily cannot be invoked in litigation enforcing a federal statute that does not itself authorize fees. *F.D. Rich Co., Inc. v. Indus. Lumber Co., Inc.*, 417 U.S. 116, 126-31 (1974).

93. See *Alyeska Pipeline Serv. Co. v. Wilderness Society*, 421 U.S. 240, 282-84 (1975) (Marshall, J., dissenting).

94. The Court's opinion in *Alyeska Pipeline* describes *Trustees v. Greenough* as holding that the 1853 Act specifying taxable costs in federal courts did not interfere with "the historic power of equity to permit the trustee of a fund or property, or a party preserving or recovering a fund for the benefit of others in addition to himself, to recover his costs, including his attorneys' fees." *Alyeska Pipeline*, 421 U.S. at 257. Justice Marshall's dissent argues that the Court in *Trustees* held more broadly that the 1853 Act did not interfere with the courts' inherent powers, whether used to shift fees in a common fund case or in some new setting to which either a common fund or bad faith theory applied. *Id.* at 278-79 (Marshall, J., dissenting).

95. See John P. Dawson, *Lawyers and Involuntary Clients: Attorney Fees from Funds*, 87 Harv. L. Rev. 1597, 1601 (1974).

tiff only when the plaintiff brings a claim in bad faith. A bad faith "exception" to a general rule of pro-plaintiff fee shifting would be consistent with the courts' inherent powers to discourage fraudulent litigation.<sup>96</sup> Although the litigation model simulated in this Article does not take fraudulent litigation into account, it is evident that the model provides support for the bad faith exception. Bad faith litigation is simply a type of tort.<sup>97</sup> The costs imposed by bad faith litigation are the costs borne by the defendant. Shifting the litigation costs to the plaintiff is equivalent to requiring the plaintiff to pay compensatory damages. The Court adopted this general standard in *Christiansburg Garment Co. v. EEOC*,<sup>98</sup> which declared the Proplaintiff rule with a bad faith exception to be the standard governing two-way fee shifting required by statutes that award fees to the prevailing party, such as Section 1988.<sup>99</sup>

What should a plaintiff do in order to be deemed "prevailing" under a statute awarding fees to the prevailing party? Should a plaintiff who wins only a nominal award be allowed to shift his attorney's fees to the defendant? The results of the model simulations support a liberal interpretation of the term "prevailing." Pro-plaintiff fee shifting provides an important benefit: it enhances compliance. This enhancement is the result of incentives provided to victims whose losses range from trivial to large. A rule denying fees to plaintiffs whose damages fail to meet a certain threshold level reduces compliance incentives by barring suits by plaintiffs below the threshold. Such a bar would probably have a substantial effect on compliance incentives for two reasons. First, small injury plaintiffs are likely to be the largest class of plaintiffs.<sup>100</sup>

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96. See Jane P. Mallor, *Punitive Attorneys' Fees for Abuses of the Judicial System*, 61 N.C. L. Rev. 613 (1982); Dan B. Dobbs, *Awarding Attorney Fees Against Adversaries: Introducing the Problem*, 1986 Duke L. J. 435, 441-44.

97. See W. Page Keeton, et. al., *Prosser and Keeton on the Law of Torts* §§ 119-21 at 870-900 (West, 5th ed. 1984). See also *Harrison v. Springdale Water & Sewer Comm'n*, 780 F.2d 1422 (8th Cir. 1986).

98. 434 U.S. 412 (1978).

99. Id. at 423. As amended, 42 U.S.C. § 1988 (1988) provides in pertinent part: "In any action or proceeding to enforce a provision of section 1981, 1981a, 1982, 1983, 1985, and 1986 of this title, title IX of Public Law 92-318 [20 U.S.C. 1681 et seq.], or title VI of the Civil Rights Act of 1964 [42 U.S.C. 2000d et seq.], the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs." Other two-way fee shifting statutes have received the same interpretation. See, for example, Civil Rights Act of 1964, 42 U.S.C. § 2000e-5(k) (1988); Toxic Substances Control Act, 15 U.S.C. §§ 2618(d), 2619(c)(2) (1988); Consumer Product Safety Act, 15 U.S.C. §§ 2060(c), 2072(a), 2073 (1988); Resource Conservation and Recovery Act of 1976, 42 U.S.C. § 6972(e) (1988).

100. Most studies of tort litigation find that injury claims are more frequent in smaller amounts. The frequency distribution of injuries typically resembles the exponential probability density. For an example, see Alfred F. Conard, et al., *Automobile Accident Costs and Payments: Studies in the Economics of Injury and Reparation* 137-52 (U. of Mich., 1964). The distributions



Second, the Proplaintiff rule encourages small injury plaintiffs to bring suit when the probability of victory is high.<sup>101</sup> Thus, a rule that effectively bars small injury plaintiffs eliminates the largest class of plaintiffs whose claims are the strongest.

One might argue that a restrictive prevailing plaintiff standard would help to screen out fraudulent litigation. While it is desirable to discourage fraudulent efforts to shift fees, this goal requires a case-by-case examination, as discussed below. Setting an award threshold below which successful plaintiffs will not be deemed "prevailing" will do nothing to discourage fraudulent or opportunistic fee requests generally. The plaintiff who receives an award above the threshold would be unaffected by a restrictive rule.

The Supreme Court has taken a liberal interpretive approach to the term "prevailing plaintiff." *Texas State Teachers Ass'n v. Garland Independent School District*<sup>102</sup> defined a prevailing plaintiff as one who has "succeed[ed] on any significant issue in litigation which achieve[d] some of the benefit the [plaintiff] sought in bringing the suit."<sup>103</sup> The Court further noted that "at a minimum . . . the plaintiff must be able to point to a resolution of the dispute which changes the legal relationship between itself and the defendant."<sup>104</sup>

Consistent with the interpretation in *Texas State Teachers*, the Court recently held in *Farrar v. Hobby*<sup>105</sup> that a plaintiff who wins only nominal damages may be eligible for a fee award under Section 1988.<sup>106</sup> *Farrar* also held, however, that the plaintiff's degree of success is the

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shown in Conard's book are "left censored" because they reflect cases in which the expected award exceeded the cost of claiming (that is, the smallest claims are not captured by the sample). The evident left censoring, however, should not disturb the picture of the underlying distribution.

101. Under the Proplaintiff rule, the plaintiff has an incentive to bring suit whenever  $P_p J > (1 - P_p)C_p$ . Assume the plaintiff is confident that he will win. In this case even a plaintiff who has suffered a very minor injury will have an incentive to bring suit.

102. 489 U.S. 782 (1989).

103. *Id.* at 789 (quoting *Nadeau v. Helgemoe*, 581 F.2d 275, 278-79 (1st Cir. 1978)).

104. *Texas State Teachers*, 489 U.S. at 792.

105. 113 S. Ct. 566 (1992).

106. *Id.* at 573. The most recent appeals court decision to adopt this interpretation is *Domegan v. Ponte*, 972 F.2d 401 (1st Cir. 1992). Before the decision in *Farrar*, two earlier Supreme Court opinions had guided courts on this question: *Hewitt v. Helms*, 482 U.S. 755 (1987), and *Rhodes v. Stewart*, 488 U.S. 1 (1988). In *Hewitt*, the Supreme Court held that the plaintiff was not entitled to a fee award under § 1988 because he had obtained no relief on any claim in litigation; "[t]he most that he obtained was an interlocutory ruling that his complaint should not have been dismissed for failure to state a constitutional claim." *Hewitt*, 482 U.S. at 760. In *Rhodes*, the Supreme Court reversed a § 1988 fee award, observing that the "case was moot before judgment issued, and the judgment therefore afforded the plaintiffs no relief whatsoever" since one inmate died and the other was released from custody prior to judgment. *Rhodes*, 488 U.S. at 4. The plaintiff victories in *Rhodes* and *Hewitt* are examples of purely technical or de minimis victories that would not lead to a fee award under the *Texas State Teachers* standard. In the courts of appeals that have considered the nominal awards problem, the basic issue has been whether a nominal

most important factor in determining the reasonableness of an award.<sup>107</sup> Therefore, the plaintiff in *Farrar*, who sought seventeen million dollars but won only nominal damages, was not entitled to a fee award.<sup>108</sup> How lower courts will interpret the muddled ruling of *Farrar* is unclear. If courts read the second part of the holding as limited to the particular facts of *Farrar*, then it would remain within courts' discretion in the vast majority of cases to award fees to plaintiffs whose injuries are small. This outcome is preferable if compliance incentives are to be maintained.

### B. What Fees Should Be Shifted?

The results of the model simulations provide support for a liberal interpretation of the word "fee" in statutes that provide for pro-plaintiff fee shifting. Viewed in terms of this guideline, the Court's record has been spotty.

In its most recent decision, *West Virginia University Hospitals v. Casey*,<sup>109</sup> the Court took a wooden approach, holding that fees for services rendered by experts in civil rights litigation may not be shifted to the losing party as part of a reasonable attorney's fee under Section 1988.<sup>110</sup> The Court offered no policy argument in support of the decision; its sole justification was that a literal reading of Section 1988 failed to reveal an intention on the part of Congress to shift experts' fees to the losing party.<sup>111</sup>

Statutes that permit shifting reasonable attorneys' fees in favor of prevailing plaintiffs should be understood to require the application of something similar to a bad faith standard. The statutes should apply an expansive standard that would avoid providing incentives for plaintiffs to inflate fees, prolong litigation, or pursue frivolous claims. Expenses for which the fee shifting statute or the definition of costs in 28 U.S.C. Section 1920<sup>112</sup> do not explicitly provide should nevertheless be shifted as long as they are expenses that an attorney would ordinarily incur in

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award should be considered equivalent to the interlocutory ruling in *Hewitt*, or the moot-before-judgment finding in *Rhodes*.

107. *Farrar*, 113 S. Ct. at 574-75.

108. *Id.* at 575.

109. 111 S. Ct. 1138 (1991).

110. *Id.* at 1148. The Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071, now allows winning plaintiffs to collect expert witness fees. Civil Rights Act of 1991 § 113, 105 Stat. at 1079.

111. *Casey*, 111 S. Ct. at 1147.

112. Section 1920 provides in pertinent part:

A judge or clerk of any court of the United States may tax as costs the following: (1) Fees of the clerk and marshal; (2) Fees of the court reporter for all or any part of the stenographic transcript necessarily obtained for use in the case; (3) Fees and disbursements for printing and witnesses; (4) Fees for exemplification and copies of papers necessarily obtained for use

a reasonably efficient effort to prosecute the plaintiff's case. Thus, travel expenses and telephone bills, which civil rights courts routinely tax against losing defendants although neither Section 1988 nor Section 1920 explicitly provide for them, would fall within the definition of a reasonable attorney's fee.<sup>113</sup> Paralegal<sup>114</sup> and expert witness fees would also be included in the fee. A liberal bad faith standard would give discretion to the court in awarding fees, but the general aim of such a standard would be to deny plaintiffs' attempts to shift costs that are beyond those an average attorney<sup>115</sup> would be expected to incur in the case. A liberal bad faith standard also would remove the incentive inherent in a pro-plaintiff fee shifting rule for plaintiffs to lengthen the proceedings. In light of this standard one can expand upon and partially justify the decision in *City of Riverside v. Rivera*.<sup>116</sup>

In *Rivera* the Court held that federal courts must consider the proportion of legal costs to damages in considering the reasonableness of an attorney's fee.<sup>117</sup> The model of litigation presented in this Article makes no attempt to take into account the problem of opportunism and for this reason suggests that no requirement should be imposed that the relationship between costs and damages be examined. If costs are necessary or reasonable, then any effort to limit them by referring to the amount of the damage payment will only discourage victims with claims that are costly to prove from bringing suit, or, alternatively, encourage defendants to adopt uncompromising litigation strategies.<sup>118</sup> Of course,

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in the case; (5) Docket fees under section 1923 of this title; (6) Compensation of court appointed experts, compensation of interpreters, and salaries, fees, expenses, and costs of special interpretation services under section 1828 of this title.

28 U.S.C. § 1920 (1988).

113. *Casey*, 111 S. Ct. at 1151.

114. The Court in *Missouri v. Jenkins*, 491 U.S. 274, 284-89 (1989), held that the term "reasonable attorney's fee" in § 1988 includes the fees of paralegals.

115. An average attorney is one whose skills meet the average of the appropriately defined community of attorneys.

116. 473 U.S. 1315 (1985).

117. *Id.* at 1321. The amount of the award is one of the twelve factors enumerated in *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974). The twelve factors that measure the reasonableness of an attorney's fee are: (1) the time and labor required; (2) the novelty and difficulty of the questions involved; (3) the skill requisite to perform the legal service properly; (4) the preclusion of employment by the attorney due to acceptance of the case; (5) the customary fee; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or the circumstances; (8) *the amount involved and the results obtained*; (9) the experience, reputation, and ability of the attorney; (10) the "undesirability" of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases. *Id.* at 717-19 (emphasis added).

118. See *Lipsett v. Blanco*, 975 F.2d 934, 939 (1st Cir. 1992) (discussing the Stalingrad defense, which amounts to forcing the plaintiff to win every victory from rock to rock and tree to tree). In a regime in which fee awards are limited to an amount less than or equal to the amount the plaintiff collects in damages, defendants' potential losses from overly aggressive litigation are

this conclusion follows only because the model has assumed that the problem of bad faith litigation does not exist.

Because lawyers who represent plaintiffs suing under a pro-plaintiff fee shifting rule will have incentives to inflate fees,<sup>119</sup> some effort must be made to deter this behavior. In determining the reasonableness of a fee request, the proper comparison is between the *expected* level of damages and the requested fee. Jury verdicts can result in overcompensation or undercompensation. Determining the reasonableness of the fee request by comparing the request to the amount of damages punishes the plaintiff who receives less than his estimate of the expected value of the judgment calculated at the time the legal expenses were incurred.

Using the terms introduced earlier in this Article, particularly in Part III, instead of comparing  $J$  and  $C_p$  as the *Rivera* Court suggested,<sup>120</sup> the reasonableness of the fee request should be based on a comparison of  $C_p$  and  $P_p E(J)$ , where  $E(J)$  is the expected damage judgment. The comparison is further complicated by the fact that the plaintiff is operating under a pro-plaintiff fee shifting rule; the plaintiff generally will spend more on litigation because he expects to have his fees shifted if he wins. A proper test for opportunism would therefore hold a fee request unreasonable if and only if

$$C_p > P_p E(J)/(1 - P_p).$$

To see the difference between the test proposed in this Article and the hindsight test urged by Justice Rehnquist in *Rivera*, consider the case in which the court will set  $J$  equal to 100 with probability 1/5 and  $J$  equal to 200 with probability 4/5. Further assume that the plaintiff's

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reduced by the existence of a ceiling on the plaintiff's award. See Thomas D. Rowe, Jr., *The Supreme Court on Attorney Fee Awards, 1985 and 1986 Terms: Economics, Ethics, and Ex Ante Analysis*, 1 *Georgetown J. Legal Ethics* 621, 624-26 (1988).

119. For a recent discussion of the problem, see Monique Lapointe, Note, *Attorney's Fees in Common Fund Actions*, 59 *Fordham L. Rev.* 843, 848-52 (1991).

120. Rehnquist does not state a mathematical rule in the *Rivera* opinion. His discussion clearly suggests, however, that courts should compare the judgment with the requested fee. The most illuminating part of the opinion appears in the next to last paragraph:

The billing experience I gained in 16 years of private practice strongly suggests to me that a very reasonable client might seriously question an attorney's bill of \$245,000 for services which had resulted solely in a monetary award of less than \$34,000. In this sense nearly all fees are to a certain extent "contingent," because the time billed for a lawsuit must bear a reasonable relationship not only to the difficulty of the issues involved but to the amount to be gained or lost by the client in the event of success or failure. Nothing in the language of § 1988 or in the legislative history set forth above satisfies me that Congress intended to dispense with this element of billing judgment when a court fixes attorney's fees pursuant to the statute.

*Rivera*, 473 U.S. at 1321. The text argues that this statement reveals a misunderstanding of the economics of fee shifting.

estimate of the likelihood of a verdict in his favor is 4/5 throughout the trial. Then the expected judgment is equal to

$$P_p E(J) = (4/5)[(1/5)(100) + (4/5)(200)] = \$144.$$

Multiplying the expected judgment by five yields \$720. Suppose the requested bill is \$500. Evaluated ex ante, the attorney's expenses would have been reasonable since the expected cost is less than the expected judgment. Evaluated in terms of the ex post test suggested by Rehnquist, the attorney's bill would be considered quite unreasonable. Generally, whenever the plaintiff has a high probability of winning (that is, a strong claim) coupled with a low probability of a very small award, it is likely that bills will appear opportunistic ex post, although they were reasonable ex ante.

One problem with the approach urged here is that the expected level of damages from the victim's perspective changes over time.<sup>121</sup> An accurate approach to the determination of reasonableness would try to take into account upward revisions in the plaintiff's expected recovery since such revisions would lead the plaintiff to invest more in litigation as the trial proceeds. So many factors should be taken into account in determining reasonableness, however, that a simple test should be applied initially.

A simple approach to the determination of reasonableness would take the final judgment as the expected judgment and simply multiply by the odds ratio  $P_p/(1 - P_p)$ . If the plaintiff's probability of winning is one-half, then this approach is equivalent to Rehnquist's ex post test. If the plaintiff's estimate of the likelihood of winning should have been less than one-half, then the requested fee would appear opportunistic if it exceeds the final judgment. If the plaintiff's estimate of the probability of winning should have been greater than one-half, then a fee request larger than the final judgment would not immediately suggest opportunism. Even this simplified test is not easy to apply. How, for example, would a court discover evidence on the plaintiff's estimate of the probability of victory? No alternative exists, however, to the test proposed here. The ex post test suggested by Rehnquist arbitrarily punishes victims with strong claims.<sup>122</sup>

121. Most economic models of litigation, such as the one examined in this Article, simplify matters by treating litigation as a one-stage procedure. A more realistic approach, however, would treat litigation as a series of motions, each with its own cost and probability of success. William Baxter made this point, among others, in an original and perceptive discussion of the economics of antitrust litigation. See Robert D. Tollison, ed., *The Political Economy of Antitrust: Principal Paper by William Baxter* 3 (Lexington Books, 1979).

122. Consider, in light of the test suggested in the text, fee and award levels of \$240,000 and \$30,000, which are similar to the numbers in *Rivera*. Using the test suggested here, one should solve for the value of  $P_p$  such that  $P_p/(1 - P_p)[30,000] = 240,000$ . The solution is  $P_p = 8/9$ . An

This Part further explores the Court's treatment of fee enhancement. The Court has proposed three types of enhancement: enhancement to compensate for the risk of loss, for exceptional success, and for the superior quality of counsel. In *Blum v. Stenson*,<sup>123</sup> the Court authorized federal courts to enhance fee awards in cases of exceptional success.<sup>124</sup> In *City of Burlington v. Dague*,<sup>125</sup> the Court denied federal courts the authority to enhance fees (the lodestar) to compensate for the risk of loss.<sup>126</sup> In *Pennsylvania v. Delaware Valley Citizens' Council for Clean Air*,<sup>127</sup> the Court held that the lodestar cannot be enhanced to reflect the superior quality of counsel.<sup>128</sup> The following remarks focus on the first two types of enhancement—for risk of loss and for exceptional success.

As a preliminary matter one should note that it is difficult to reconcile the decisions in *Blum* and *City of Burlington*. What defines exceptional success if not a case in which the plaintiff wins when the risk of loss was high? The Court has not explained the difference between these cases and made no effort to overrule *Blum* in its *City of Burlington* opinion.<sup>129</sup> Despite this discrepancy, this Article assumes that *Blum* has been overruled by *City of Burlington*. The reason the *City of Burlington* Court gave for denying federal judges authority to enhance fees applies with equal force to *Blum*. If *City of Burlington* did not overrule *Blum*, then every attorney who wishes to have her fees enhanced in a case in which the risk of loss was high could simply argue that her victory is a case of "exceptional success."<sup>130</sup> Exceptional success and high risk of loss are indistinguishable categories, and are treated as one be-

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appropriate "quick" test of the reasonableness of the fee request in *Rivera* then would require one to determine whether 8/9 seemed to be a reasonable estimate of the plaintiff's probability of prevailing when the legal expenses were incurred. Although the information necessary to make a reasonableness assessment is not available, 8/9 is a rather high ex ante probability of victory and seems to be outside of the range of ordinary success probabilities. George Priest and Benjamin Klein have shown that in many areas of litigation,  $\frac{1}{2}$  seems to be an accurate estimate of the ex ante probability of success for the plaintiff. See George L. Priest and Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. Legal Stud. 1 (1984). Areas of litigation exist, however, in which one observes success probability estimates greater than  $\frac{1}{2}$ . For a theory that reconciles these observations with the theory of Priest and Klein, see Keith N. Hylton, *Asymmetric Information and the Selection of Disputes for Litigation*, 22 J. Legal Stud. 187 (1993).

123. 465 U.S. 886 (1984).

124. *Id.* at 899.

125. 112 S. Ct. 2638 (1992).

126. *Id.* at 2643-44.

127. 478 U.S. 546 (1986).

128. *Id.* at 567.

129. The *City of Burlington* Court appeared not to recognize any contradiction between the holdings. In contrast, the majority opinion referred to *Blum* in support of its decision. See *City of Burlington*, 112 S.Ct. at 2641.

130. *Blum*, 465 U.S. at 899.

low. The following discussion focuses on the argument for enhancement to compensate for risk of loss.

On economic grounds, it is hard to see why courts should enhance the fee award for risk of loss. A rational, profit-maximizing attorney will prosecute a plaintiff's claim if and only if the expected payment from the client exceeds the cost of prosecuting the claim. The plaintiff will prefer to bring suit only if the expected award exceeds his payment to the attorney. Given these conditions, enhancement should never be necessary because claims that are not profitable *ex ante* will not be brought.

Justice Scalia has argued that if a claim is risky, that fact will be reflected in the fees because the number of hours required to prepare the case will be greater and the market rate for the claim will be higher.<sup>131</sup> The first proposition is wrong as a general matter. As the probability of a verdict in favor of the plaintiff falls, an attorney will generally have less incentive to invest time in litigation, irrespective of the fee shifting rule in effect.<sup>132</sup> Scalia's argument appears to be based on some notion that a minimum number of hours is required to research or prepare a given type of claim; he further assumes that as one moves into riskier claims, the minimum increases. These assumptions may be valid, although no empirical evidence exists to support them. Even if valid, however, the effect identified by Scalia is offset by the profit-maximization incentive, which generally will lead an attorney to reduce his time investment as the probability of a plaintiff victory decreases. Thus, even if Scalia's underlying premise is accepted, only one safe conclusion exists: it is unclear how the riskiness of a claim affects a plaintiff's time investment. The second of Scalia's propositions—that market rates generally will be higher for riskier claims—is probably true within one class of claims: antitrust claims. The demand for litigation, however, varies across classes of claims. For a class in which the demand is low, either because few victims exist or because the victims

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131. He asserted:

We note at the outset that an enhancement for contingency would likely duplicate in substantial part factors already subsumed in the lodestar. The risk of loss in a particular case (and, therefore, the attorney's contingent risk) is the product of two factors: (1) the legal and factual merits of the claim, and (2) the difficulty of establishing those merits. The second factor, however, is ordinarily reflected in the lodestar—either in the higher number of hours expended to overcome the difficulty, or in the higher hourly rate of the attorney skilled and experienced enough to do so.

*City of Burlington*, 112 S. Ct. at 2641.

132. Compare Ronald Braeutigam, Bruce Owen, and John Panzar, *An Economic Analysis of Alternative Fee Shifting Systems*, 47 L. & Contemp. Probs. 173, 183-84 (1984) (proving that the incentive to invest increases with the stakes).

are generally poor, market rates may be much lower than for comparably risky claims drawn from a pool of corporate clients.

Although Justice Scalia's economic analysis in *City of Burlington* is unsound, the conclusion that enhancement for risk should be unnecessary seems defensible for reasons other than those offered by Scalia. Because rational attorneys will prosecute only those claims for which the expected judgment exceeds the expected cost of litigation, the argument that enhancement is necessary to attract competent attorneys fails.<sup>133</sup> This argument is as defensible as the claim that a price-fixing conspiracy among ice cream parlor operators within a city is necessary to attract competent people into the business of selling ice cream. Both claims assert that it is necessary for the party on the other side of the transaction—the defendant in the litigation example, the consumer in the ice cream case—to pay a larger amount in order to subsidize the activity. This argument begs the question whether risky claims should be subsidized at all.

Subsidizing risky claims by enhancing fee awards in cases in which the probability of a plaintiff victory is low will have several effects on litigation in the field in which the subsidy operates. First, subsidization will attract attorneys into the subsidized field by increasing the returns from litigation. For attorneys already in the subsidized field, subsidization will increase the amount of effort invested into risky (that is, low-probability-of-victory) claims. In addition, subsidization will lead to an increase in the number of risky claims brought within the subsidized field of litigation. No reason has yet been given why courts should encourage low-probability-of-victory claims.

Low-probability-of-victory claims are likely to be of two types: claims that test a new legal proposition that the court is unlikely to accept and claims that are weak because the plaintiff may not have been injured.<sup>134</sup> There appears to be no reason for encouraging claims with weak factual bases. Subsidization of such claims tends to encourage the type of frivolous suits that courts traditionally have tried to

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133. For an alternative analysis, see Warren F. Schwartz and Clinton F. Beckner III, *City of Burlington v. Dague: The Supreme Court Searches for the Optimal Attorney's Fee in a World of Legal Uncertainty* (1993) (unpublished draft, Georgetown University Law Center, on file with Professor Keith N. Hylton). See also Charles Silver, *Incoherence and Irrationality in the Law of Attorneys' Fees*, 12 Rev. Litig. 301 (1993).

134. For example, low-probability-of-victory claims include claims in which the plaintiff is unlikely to prove injury. The classic example of such a case is an antitrust or a securities plaintiff who claims that he was injured by the defendant's behavior because the market price of an item was so high that he was discouraged from purchasing the item. The antitrust and securities laws generally have denied standing to such plaintiffs based on their inability to prove damages. See, for example, *Kreager v. General Elec. Co.*, 497 F.2d 468 (2d Cir. 1974) (discussing standing in antitrust cases); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (discussing standing in securities cases).



discourage through the use of inherent sanctioning powers. Further, no apparent benefits result from encouraging plaintiffs to test legal propositions that courts are likely to reject. If subsidized plaintiffs are successful, they will be encouraged to attempt to have the law rewritten to meet their preferences. There is simply no guarantee that this type of litigation would result in desirable changes in the law. Plaintiffs likely would be encouraged to seek changes that benefit themselves at the expense of society. Although this type of opportunistic litigation is not included within the traditional definition of frivolous litigation, the liberal bad faith standard still would seek to remove its incentives. If plaintiffs' attempts to change the law were unsuccessful, the subsidization efforts would have been wasted. Neither outcome offers a clear social gain.

The argument concerning fee enhancement extends to the Court's decision in *Hensley v. Eckerhart*,<sup>135</sup> which held that hours of work spent on unsuccessful claims that are distinct from successful claims must be excluded from a fee award.<sup>136</sup> If the hours spent on separable unsuccessful claims could be billed along with hours spent on successful claims, plaintiffs would have an incentive to increase the number of claims they bring without regard to their likelihood of success.<sup>137</sup> Because plaintiffs already have an incentive to bring strong claims forward, including in fees hours spent on unsuccessful claims would only encourage plaintiffs to pursue weaker claims. It seems undesirable to substitute weaker claims in place of claims more likely to succeed.<sup>138</sup>

135. 461 U.S. 424 (1983).

136. *Id.* at 440.

137. Of course the possibility of Rule 11 sanctions deters some of this behavior. A substantial gray area exists, however, between claims that invite sanctions and claims that are merely unlikely to prevail. See, for example, *Westmoreland v. CBS, Inc.*, 770 F.2d 1168, 1180 (D.C. Cir. 1985) (stating that creative litigation is encouraged and that aggressive litigation should not be penalized). The claims within this gray area would be encouraged by including hours spent on unsuccessful claims in the lodestar.

138. This discussion has ignored legislative intent. One might argue that the legislature intended to promote bringing weaker civil rights claims when it enacted § 1988. That argument is not pursued here. One should note, however, that nothing in the legislative history supports it:

[T]here is no evidence, however, that Congress, in considering § 1988, had any thought that civil rights claims were to be on any different footing from other civil claims insofar as settlement is concerned. Indeed, Congress made clear its concern that civil rights plaintiffs not be penalized for helping to lessen docket congestion by settling their cases out of court.

*Evans v. Jeff D.*, 475 U.S. 717, 733 (1986) (quoting *Marek v. Chesny*, 473 U.S. 1, 10 (1985)).

For a discussion of doubts about the desirability of encouraging substitution toward weaker claims, see John Leubsdorf, *The Contingency Factor in Attorney Fee Awards*, 90 Yale L. J. 473, 482-97 (1981). Leubsdorf argues in favor of enhancing awards by the same percentage in areas that are considered relatively risky or unremunerative. *Id.* at 501-12. His argument appears entirely consistent with the analysis presented in this Article. The text, however, considers only whether it is desirable within a class of claims to subsidize the riskier ones.

C. *The Conflict Between Settlement and Compliance Incentives*

Two recent Supreme Court cases have addressed the possible conflict between fee shifting rules that promote settlement incentives and rules that enhance incentives to comply with the law. In *Evans v. Jeff D.*,<sup>139</sup> the Court held that federal courts have the discretion to approve settlements conditioned upon waiver of fee awards under the Civil Rights Attorney's Fees Awards Act of 1976.<sup>140</sup> In *Marek v. Chesny*,<sup>141</sup> the Court held that the term "costs" in Rule 68 of the Federal Rules of Civil Procedure<sup>142</sup> includes attorneys' fees when the plaintiff's claim is based on a statute that both authorizes courts to tax costs against the losing party and includes attorneys' fees within the set of the costs that may be taxed.<sup>143</sup> Thus, a prevailing civil rights plaintiff who receives less from the judgment than he would have received from the defendant's final settlement offer is precluded under Rule 68 from shifting his attorney's fees to the defendant, although Section 1988 permits such shifting.

In each of these opinions the Court argued that its holding was required by the terms of the relevant statute. In *Evans* the Court explained that nothing in the text or the history of the Civil Rights Attorney's Fees Awards Act of 1976 suggested that Congress intended to deny courts the authority to approve settlements conditioned upon waiver of fee awards.<sup>144</sup> Similarly, the Court justified *Marek* as a straightforward interpretation of Rule 68.<sup>145</sup> Both opinions, however, offered the additional justification that the decision encouraged settlement.<sup>146</sup> To deny federal courts the discretion to approve settlements conditioned upon waiver of fee awards would restrict the set of feasible settlement packages, and thereby reduce the rate of settlement.<sup>147</sup> In *Marek*, the Court's policy argument was grounded on the generally accepted intention of Rule 68: to encourage settlement.<sup>148</sup> Dissents by Justice Brennan in both cases noted that the Court was placing the pol-

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139. 475 U.S. 717 (1986).

140. *Id.* at 737-38. The Civil Rights Attorney's Fees Awards Act is codified at 42 U.S.C. § 1988 (1988).

141. 473 U.S. 1 (1985).

142. F.R.C.P. 68 provides that if a timely pretrial offer of settlement is not accepted and "the judgment finally obtained by the offeree is not more favorable than the offer, the offeree must pay the costs incurred after the making of the offer."

143. *Marek*, 473 U.S. at 9.

144. *Evans*, 475 U.S. at 742-43.

145. *Marek*, 473 U.S. at 5-7.

146. *Id.* at 11; *Evans*, 475 U.S. at 733-37.

147. *Evans*, 475 U.S. at 732; *Marek*, 473 U.S. at 6-7.

148. *Marek*, 473 U.S. at 11.

icy of encouraging settlement above that of encouraging compliance with the civil rights laws.<sup>149</sup>

The results presented in this Article suggest that no conflict may exist between cost allocation rules that encourage settlement and rules that encourage compliance. If the model simulations are valid predictions of the compliance and settlement results under the various fee shifting rules, then the Proplaintiff rule established by the Civil Rights Attorney's Fees Awards Act of 1976 should encourage compliance *and* settlement. The rule should encourage compliance because it gives civil rights victims a strong incentive to sue. It should encourage settlement because the probability that the defendant is guilty, given that the plaintiff has brought suit, is smallest under the Proplaintiff rule. As a result, the settlement gap is narrower under pro-plaintiff fee shifting than under the other fee rules. The Court did not consider the possibility that no tension exists between fee rules promoting compliance and fee rules promoting settlement in either the majority or the dissenting opinions of *Marek* and *Evans*.

If no conflict exists between fee rules that promote compliance and rules that promote settlement, then the reasoning of the majority and dissenting opinions in *Marek* and *Evans* falls apart. The no-conflict result inflicts greater damage, however, on the majority opinions of both cases. The majority opinions sought to limit the scope of pro-plaintiff fee shifting in order not to discourage settlement. The Court based its views entirely on speculation, however, for it had no empirical evidence that the enforcement of a pro-plaintiff fee shifting rule discouraged settlement.

It is possible that the model simulations' results are not valid predictions because the model has taken a simplistic approach to incentives under fee shifting. Kathryn Spier recently demonstrated that a Rule 68-like fee shifting rule has the desirable property of encouraging parties to reveal private information, which increases the probability of settlement.<sup>150</sup> Perhaps a more general model in which parties choose

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149. *Evans*, 475 U.S. at 743 (Brennan, J., dissenting); *Marek*, 473 U.S. at 15 (Brennan, J., dissenting). The Court noted the tension between settlement and litigation incentives and took an approach consistent with Brennan's view in *Delta Air Lines, Inc. v. August*, 450 U.S. 346, 350 (1981), which held that Rule 68 is inapplicable when the defendant obtains the judgment.

150. See Kathryn E. Spier, *Pretrial Bargaining and Fee-Shifting Mechanisms: A Theoretical Foundation for Rule 68* (June 1992) (unpublished manuscript, on file with the author, Dep't of Economics, Harvard U.). Note that the text uses the term "Rule 68-like." Spier's model assumes a two-way fee shifting rule similar in operation to Rule 68. Of course, Rule 68 shifts in only one direction (from the plaintiff to the defendant) and does not shift fees.

In an earlier theoretical examination of Rule 68, George Priest found that the rule encourages settlement under certain conditions and encourages litigation under other conditions. See George L. Priest, *Regulating the Content and Volume of Litigation: An Economic Analysis*, 1 S. Ct. Econ. Rev. 163 (1982). He concluded that the Rule's more likely effect is to encourage litigation. *Id.* at

whether to comply and to reveal private information in the course of litigation might support the more intuitive conclusion that fee rules that promote compliance do so at the expense of discouraging settlement.

Thus, a more general model of litigation might provide a justification for the Supreme Court's decision in *Marek*. This conclusion is problematic in that it rests on the assumption that courts do not err in determining liability. In a regime in which courts make mistakes, a Rule 68-like fee shifting rule may not enhance truth-telling in settlement negotiations. If, for example, courts generated random "yes" or "no" verdicts on the question of liability, the parties' incentives in settlement negotiations would be affected, but probably not in a manner that encouraged truth-telling. More generally, if courts fail to determine accurately guilt or innocence or the level of damages, little reason exists to believe that parties will reveal the truth during settlement negotiations, whatever the applicable fee shifting rule. Parties' actions during settlement negotiations will be based on forecasts of what the court is likely to do. If predictable errors or biases are evident in the court's decision-making process, the parties will take them into account at the settlement stage, and settlement demands will reflect the errors, regardless of their relationship to the truth.

Assume that the Court's intuition is correct—that the incentive effects of fee rules that promote compliance conflict with those that promote settlement. The question that follows is whether the incentive to comply is a more important concern than the incentive to settle. That question cannot be answered without some well-defined notion of social welfare. It is not enough to adopt a goal such as minimizing the costs of injury, the costs of avoiding injury, plus the administrative costs of the court system. Even this simple test requires that some estimates be made of the components of the welfare function before it can be used to analyze the tradeoff between compliance and settlement incentives.

A final resolution of these issues will require empirical examination of the effects of fee shifting on compliance and settlement rates. In light of this fact, perhaps the most troubling aspect of the majority opinions in *Marek* and *Evans* is that the Court staked its policy argument on empirical assumptions that are as yet unsupported by evidence. On the other hand, waiting for empirical evidence in this area is problematic; it may never come. No natural experiments would allow comparison of the incentive effects of alternative fee shifting rules.

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164-65. Geoffrey Miller found that Rule 68 encourages settlement slightly but that its more significant effect is to transfer wealth from plaintiffs to defendants. See Geoffrey P. Miller, *An Economic Analysis of Rule 68*, 15 J. Legal Stud. 93 (1986).

D. *Some Implications for the History of Fee Shifting Doctrine, and Speculative Remarks*

The suggestion that the rule the Court adopted in *Christiansburg Garment* should apply generally to all litigation may appear foolhardy because it seems to be outside the range of experience. One might argue that general patterns of fee shifting in favor of prevailing plaintiffs are not apparent, because earlier generations likely discovered that such fee shifting was unwise. The current practice reflects traditions that have survived because they were superior to alternative practices; at the least, a system that has worked for so long should be changed only with great care.

This appeal to doctrinal stability is misplaced, at least where fee shifting is concerned. While there appears to be no country in which fee shifting in favor of prevailing plaintiffs is now the norm, it was the original practice in English courts. Blackstone asserted that fees generally were included in damages, although no explicit statutory or common-law rule authorized the practice.<sup>151</sup> At the same time, fines were used to penalize frivolous litigants.<sup>152</sup>

What led to the American and British rules that predominate today? It seems that the common-law practice fell victim to interest group legislation everywhere. The British rule is the result of a series of statutes, beginning with the codification of the practice of awarding fees to prevailing plaintiffs in the Statute of Gloucester of 1275.<sup>153</sup> The codification effort appears to have given rise to efforts to shift fees in favor of prevailing defendants,<sup>154</sup> leading finally to a statute that awarded costs to prevailing defendants in all actions in which a plaintiff might recover costs.<sup>155</sup> The American rule, on the other hand, seems to have been the unintended byproduct of mercantilist interests. The capping of lawyers' fees in Colonial era statutes appears to have been part of a general pattern of legislating ceilings on the wages that various labor

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151. Blackstone, 3 *Commentaries* at \*399 (cited in note 8).

152. *Id.* at \*398-99.

153. 6 Edw. 1, ch.1. See John Hullock, *Law of Costs* 4 (1793). For a good, fairly recent discussion of the development of the British system, see William B. Stoebuck, *Counsel Fees Included in Costs: A Logical Development*, 38 U. Colo. L. Rev. 202, 204-07 (1966).

One should note that the Statute of Marlborough of 1267 preceded that of Gloucester and awarded costs to the defendant in one particular form of action. See Stoebuck, 38 U. Colo. L. Rev. at 204. Because the statute awarded costs to the defendant only when the suit was "malicious," see Hullock, *Law of Costs* at 124, it should not be considered in the same class of general fee shifting statutes discussed here.

154. Stoebuck, 38 U. Colo. L. Rev. at 204 (cited in note 153).

155. 4 Jac. 1, ch.3. See Hullock, *Law of Costs* at 125 (cited in note 153).

groups could demand.<sup>156</sup> The fee ceilings could be evaded easily by a lawyer and his client; this practice of evasion gave rise to the American rule.<sup>157</sup> It was much easier for lawyers to challenge the statutory ceilings on charges to their own clients than the ceilings on charges to the opposing party.<sup>158</sup>

The recommendation of a general rule shifting fees in favor of prevailing plaintiffs seeks nothing more than a return to the common-law practice. The argument that it is wise to stick with time-honored practices weighs in favor of this recommendation.

## V. CONCLUSION

Rules of civil procedure typically are treated as if they have no effect on incentives to comply with the law. On the other hand, fee shifting provisions of federal statutes, such as the Civil Rights Attorney's Fees Awards Act of 1976, often are justified by reference to predicted effects on ex ante incentives. The consequence is that the theoretical analysis of procedural rules is incomplete and somewhat confusing. An adequate theory of procedural rules should take into account their influence on ex ante incentives, and the justifications of fee shifting statutes should be based on something more than pure hunch.

This Article has examined the influence of fee shifting on ex ante incentives within a model of litigation. The Article examined four fee shifting rules: the American rule, the British rule, fee shifting in favor of the prevailing plaintiff (the Proplaintiff rule), and fee shifting in favor of the prevailing defendant (the Prodefendant rule). The influence of each of these rules was examined under three information regimes: one in which the plaintiff enjoys an informational advantage in litigation, a second in which the defendant enjoys an informational advantage in litigation, and a third in which neither party enjoys an informational advantage. A surprisingly consistent result emerged: fee shifting in favor of prevailing plaintiffs enhances both incentives to comply with legal rules *and* incentives to settle disputes.

Part IV of this Article examined the implications of the model's results for Supreme Court decisions interpreting fee shifting statutes. The results presented in this Article support the Supreme Court's decision in *Christiansburg Garment* to read a double standard into the provision of the 1964 Civil Rights Act that shifts the fees of the prevailing

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156. For the theory that mercantilist interests demanded such ceilings, which were generally accepted because of the dominance of mercantilist theories, see Richard B. Morris, *Government and Labor in Early America* (Octagon Books, 1946).

157. See John Leubsdorf, *Toward a History of the American Rule on Attorney Fee Recovery*, 47 L. & Contemp. Probs. 9, 10-13 (1984).

158. *Id.* at 13.

party. The double standard of *Christiansburg Garment* permits fee shifting in favor of prevailing plaintiffs generally, but in favor of prevailing defendants only in cases of bad faith on the part of the plaintiff. The more recent Supreme Court decisions have veered away from this functional approach toward an almost literal reading of the fee shifting statutes. The most interesting implication of the *Christiansburg Garment* decision concerns the supposed conflict between settlement and compliance incentives that divided the majority and dissenting opinions in *Marek v. Chesny*. This Article suggests that there may be no conflict.

## APPENDIX

## I. BASIC FEATURES

All actors in this model are risk neutral. The model assumes that victims are the only ones who suffer loss from an accident, that the risk of loss to victims can be reduced by potential injurers exercising precaution, and that it is costly for potential injurers to take care. Let  $p$  = the probability of loss if potential injurers do not take care, where  $p > 0$ ; let  $q$  = the probability of loss if injurers do take care, where  $p > q > 0$ . Let  $v$  = the loss that an accident victim suffers, where  $v > 0$ . The variable  $v$  is assumed to be random, with distribution function  $H(v)$ .

Let  $x$  = the cost to a potential injurer of taking care, where  $x > 0$ . The variable  $x$  is assumed to be random, with distribution function  $G(x)$ . The value of  $x$  is unobservable to potential victims; the injurer, however, observes and knows the value when he chooses whether to take care.

A victim sues for the value of her loss,  $v$ . The model assumes that courts occasionally make mistakes in deciding liability. With this in mind, let  $Q_1$  = the probability of type one error—that is, that the court erroneously fails to hold a defendant liable—where  $0 < Q_1 < 1$ . Let  $Q_2$  = the probability of type two error—that is, that the court erroneously holds a defendant liable—where  $0 < Q_2 < 1$ . The model further assumes that victims and injurers know  $Q_1$  and  $Q_2$ .

An injurer will be held liable only when he fails to comply with the due care standard, which is provided by the Hand formula for negligence. According to the Hand formula, an actor is negligent if he fails to take care when the cost of taking care is less than the increase in expected accident losses—that is, when  $x < (p - q)E(v)$ .

## II. COMPARISON OF COMPLIANCE EQUILIBRIA UNDER ALTERNATIVE FEE SHIFTING RULES

Four information regimes are possible in this model. First, both the plaintiff and the defendant may be uninformed. In the second and third regimes, only one of the parties is informed. In the fourth regime, both parties are informed. The following subparts examine the equilibrium in each of the first three regimes.

### A. Plaintiff Uninformed, Defendant Informed

Let  $\sigma$  = the expected cost of litigation to the defendant (which will depend on the cost allocation rule in effect). Let  $S_1$  = the expected settlement amount when the defendant does not comply with the due



care standard. Let  $S_2$  = the expected settlement amount when the defendant does comply with the due care standard.

Using the defined terms, a general description of equilibrium under negligence is as follows:<sup>159</sup>

$$W = p[gq + (1-g)p]^{-1} \int \frac{(p-q)E(v)}{dG(x)}, \\ p(1-H(v_1))S_1 - q[[H(v_2)-H(v_1)]S_2 + [1-H(v_2)][Q_2E(v|v > v_2) + \sigma]]$$

where  $g$  is the probability that the threat of liability will lead a potential injurer to take care and is given by

$$g = G[(p-q)v]G[p(1-H(v_1))S_1 - q([H(v_2)-H(v_1)]S_2 + [1-H(v_2)][Q_2E(v|v > v_2) + \sigma])].^{160}$$

### B. Plaintiff Informed, Defendant Uninformed

This subpart presents the equilibrium solutions under the four fee shifting rules. In order to simplify matters, it is assumed that the defendant's settlement offer is equal to his expected liability (litigation costs plus expected liability). This proposition is equivalent to assuming that the plaintiff has all of the bargaining power.

In this case, the defendant's estimate of the probability of a verdict in favor of the plaintiff is  $P_d = W(1 - Q_1) + (1 - W)Q_2$ . The plaintiff's estimate of the likelihood of a verdict in his favor is  $P_p = 1 - Q_1$  if the defendant is guilty and  $P_p = Q_2$  if the defendant is innocent. As explained below, rather strong assumptions are necessary to support these calculations.

#### 1. American Rule

The victim has an incentive to bring suit whenever

$$P_p v > C_p.$$

Thus, the probability that a plaintiff will bring suit given that an accident leads to loss is  $1 - H[C_p/(1 - Q_1)]$  when the defendant is guilty and  $1 - H(C_p/Q_2)$  when the defendant is innocent.

Given the definition of negligence, equilibrium under the American rule requires:

$$W = p[gq + (1-g)p]^{-1} \int \frac{(p - q)E(v)}{dG(x)}, \\ B$$

159. The derivation of the equilibrium solution is presented in a simpler model in Keith N. Hylton, *Costly Litigation and Legal Error Under Negligence*, 6 J. L. Econ. & Org. 433 (1990).

160. For a detailed discussion of the equilibrium solutions under each of the four fee shifting rules in the information regime in which the plaintiff is uninformed and the defendant is informed, see Hylton, 22 J. Legal Stud. at 455 (cited in note 5).

where  $B$  is equal to

$$p[1-H(C_p/(1-Q_1))][P_d E[vv > C_p/(1-Q_1)] + C_d] - q[1-H(C_p/Q_2)][P_d E[vv > C_p/Q_2]] + C_d],$$

and where  $g$  is the probability that the threat of liability will lead a potential injurer to take care and is given by

$$g = G[(p-q)E(v)]G(B).$$

The assumptions implicit in these equations must be noted. These equations assume first that the defendant, whether he has taken care or not, perceives his probability of being found guilty as equal to the population probability of guilt. Second, the equations imply that the defendant knows the rate at which suit is brought against defendants who take care and those who do not, but does not use this information to modify his estimate of the probability of a verdict in the plaintiff's favor. A number of explanations can be given for these assumptions. The simplest seems to be this: the equations assume that the court treats each case as indistinguishable from another and therefore the probability of a finding of guilt is equal in every case to the probability of guilt in the population.

## 2. British Rule

The victim has an incentive to bring suit whenever

$$P_p v > (1 - P_p)C.$$

Thus, the probability that a plaintiff will bring suit given that an accident leads to loss is  $1 - H[Q_1 C / (1 - Q_1)]$  when the defendant is guilty and  $1 - H((1 - Q_2)C / Q_2)$  when the defendant is innocent.

Equilibrium under the British rule requires:

$$W = p[gq + (1-g)p]^{-1} \int_B \frac{(p-q)E(v)}{dG(x)},$$

where  $B$  is equal to

$$p[1-H[Q_1 C / (1 - Q_1)]]P_d [E[vv > Q_1 C / (1 - Q_1)] + C] - q[1-H((1 - Q_2)C / Q_2)]P_d [E[vv > (1 - Q_2)C / Q_2]] + C],$$

and where  $g$  is the probability that the threat of liability will lead a potential injurer to take care and is given by

$$g = G(B).$$

## 3. Proplaintiff Rule

The victim has an incentive to bring suit whenever

$$P_p v > (1 - P_p)C_p.$$

Thus, the probability that a plaintiff will bring suit given that an accident leads to loss is  $1 - H[Q_1 C_p / (1 - Q_1)]$  when the defendant is guilty and  $1 - H[(1 - Q_2) C_p / Q_2]$  when the defendant is innocent.

Equilibrium under the Proplaintiff rule requires:

$$W = p[gq + (1-g)p]^{-1} \int_B (p - q)E(v) dG(x),$$

where  $B$  is equal to

$$p[1 - H[Q_1 C_p / (1 - Q_1)]] [P_d E[vw > Q_1 C_p / (1 - Q_1) + C_p] + C_d] - q[1 - H[(1 - Q_2) C_p / Q_2]] [P_d E[vw > (1 - Q_2) C_p / Q_2 + C_p] + C_d],$$

and where  $g$  is the probability that the threat of liability will lead a potential injurer to take care and is given by

$$g = G(B).$$

#### 4. Prodefendant Rule

The victim has an incentive to bring suit whenever

$$P_p v > C_p + (1 - P_p) C_d.$$

Thus, the probability that a plaintiff will bring suit given that an accident leads to loss is  $1 - H[(C_p + (1 - P_p) C_d) / P_p]$ .

Equilibrium under the Prodefendant rule requires:

$$W = p[gq + (1-g)p]^{-1} \int_B (p - q)E(v) dG(x),$$

where  $B$  is equal to

$$p[1 - H[(C_p + Q_1 C_d) / (1 - Q_1)]] P_d [E[vw > (C_p + Q_1 C_d) / (1 - Q_1) + C_d] - q[1 - H[(C_p + (1 - Q_2) C_d) / Q_2]] P_d [E[vw > (C_p + (1 - Q_2) C_d) / Q_2 + C_d],$$

and where  $g$  is the probability that the threat of liability will lead a potential injurer to take care and is given by

$$g = G(B).$$

#### C. Both Parties Uninformed

This subpart assumes that ex ante—that is, before the accident occurs— $P_d = P_p = W(1 - Q_1) + (1 - W)Q_2$ . Ex post,  $P_p = W(1 - Q_1) + (1 - W)Q_2$  and  $P_d = W(1 - Q_1) + (1 - W)Q_2 - \epsilon$ .

##### 1. American Rule

The victim has an incentive to bring suit whenever

$$P_p v > C_p.$$

Thus, the probability that a plaintiff will bring suit given that an accident leads to loss is  $1 - H(C_p/P_p)$ .

Equilibrium under the American rule requires:

$$W = p[gq + (1-g)p]^{-1} \int \frac{(p-q)E(v)}{dG(x)}, (p-q)[1-H(C_p/P_p)][P_d E(v > C_p/P_p) + C_d]$$

where  $g$  is the probability that the threat of liability will lead a potential injurer to take care and is given by

$$g = G[(p-q)[1-H(C_p/P_p)][P_d E(v > C_p/P_p) + C_d]].$$

The probability of litigation is  $\text{Prob}(ev > C)$ .

## 2. British Rule

Equilibrium under the British rule requires:

$$W = p[gq + (1-g)p]^{-1} \int \frac{(p-q)E(v)}{dG(x)}, (p-q)[1-H((1-P_p)C/P_p)]P_d[E(v > (1-P_p)C/P_p) + C]$$

where  $g$  is the probability that the threat of liability will lead a potential injurer to take care and is given by

$$g = G[(p-q)[1-H((1-P_p)C/P_p)]P_d[E(v > (1-P_p)C/P_p) + C]].$$

The probability of litigation is  $\text{Prob}[\epsilon(v + C) > C]$ .

## 3. Proplaintiff Rule

Equilibrium under the Proplaintiff rule requires:

$$W = p[gq + (1-g)p]^{-1} \int \frac{(p-q)E(v)}{dG(x)}, (p-q)[1-H((1-P_p)C_p/P_p)][P_d[E(v > (1-P_p)C_p/P_p) + C_p] + C_d]$$

where  $g$  is the probability that the threat of liability will lead a potential injurer to take care and is given by

$$g = G[(p-q)[1-H((1-P_p)C_p/P_p)][P_d[E(v > (1-P_p)C_p/P_p) + C_p] + C_d]].$$

The probability of litigation is  $\text{Prob}[\epsilon(v + C_p) > C]$ .

## 4. Prodefendant Rule

Equilibrium under the Prodefendant rule requires:

$$W = p[gq + (1-g)p]^{-1} \int \frac{(p-q)E(v)}{dG(x)}, (p-q)[1-H(C_p + (1-P_p)Cd/P_p)]P_d[E(v > (C_p + (1-P_p)Cd)/P_p) + C_d]$$

where  $g$  is the probability that the threat of liability will lead to a potential injurer to take care and is given by

$$g = G[(p-q)[1-H(C_p + (1-P_p)C_d/P_p)]P_d[E(v > (C_p + (1-P_p)C_d)/P_p) + C_d].$$

The probability of litigation is  $\text{Prob}[\epsilon(v + C_d) > C]$ .