Law And Economics

The Economics of the Litigation Process

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Introduction

- So far, we only discussed the cost of legal process abstractly e.g. in terms of informational requirements.

- Now instead we are interested in modeling explicitly how the costs of the litigation process might affect outcomes.

Structure of Lawsuit

0. Dispute (accident, breach, etc.)

1. Alleged victim files or not a legal claim.

2. If victim files: pre-trial bargaining.

   - Information exchange.
   - Settle or go to trial.

3. If trial occurs, then Court determines the outcome.

Why do trials occur?

- If
    - litigants are rational,
    - have same beliefs about the outcome distribution of a trial,
    - risk averse.

- One would expect agents would replicate the expected outcome with a monetary settlement.
    - Saves costs of trial.
    - Less uncertainty.

- Given Rationality and Risk Aversion: only reason trials occur is that agents have different beliefs. **Optimism or Asymmetric Information**.

Optimism Model

- Model
    - p: probability of winning for plaintiff.
    - q: defendants' probability of losing.
    - ψ: transfer if the defendant found guilty.
    - C_p: cost for plaintiff.
    - C_d: cost for defendant.

- **Assumption**: Settlement is costless. Pareto efficiency is always achieved.

Optimism Model

- Value of trial for plaintiff:

$$p\psi - C_p$$

- Assume for now that this is positive.

- Plaintiff would prefer to settle for any offer S with

$$S \geq q\psi - C_p$$

- A settlement is *feasible* if there exists an S with

$$p\psi - C_p \leq S \leq q\psi + C_d$$

- Trial will occur if

$$(p - q)\psi > C_p + C_d$$

- (Notice that this condition always holds if $q \geq p$.)

Asymmetric Information Model

- Similar to plea bargaining model.

- Model:
    - Two types of plaintiff: H (Non CN) or L (CN).
    - p_H and p_L the respective probabilities of victory.
    - Defendant doesn't observe plaintiff's type.
    - Defendant know a fraction α are H.
    - Average probability of losing for defendant:

$$\bar{p} = \alpha p_H + (1 - \alpha)p_L$$

Asymmetric Information Model

- Bargaining Assumption: defendant makes a take-it-or-leave-it offer to the plaintiff.

  - Pooling: $S = p_H \cdot \psi - C_p$.

    - Both types accept the offer. There is no trial.

  - Separating: Offer $S = p_L \cdot \psi - C_p$.

    - Low-type accepts, high types reject and go to trial.

    - Expected cost:
      $$\alpha(p_H\psi + C_d) + (1 - \alpha)(p_L\psi - C_p)$$

  - Pooling 2: Offer a low amount that is rejected by both types.

    - Expected cost:
      $$\bar{p}\psi + C_d$$

    - This is dominated by the separating offer.

Asymmetric Information Model

- Trials occur if there is a separating offer, and the plaintiff was type H.

$$\bar{p}\psi + \alpha C_d - (1-\alpha)C_p > p_H \cdot \psi - C_p$$

- Rearranging:

$$\frac{1-\alpha}{\alpha}(p_H - p_L)\psi > C_p + C_d$$

Discovery

- Transfers don't affect efficiency, but whether trials occur or not does.

- One goal is to reduce the probability of trials, keeping fixed incentives. This reduces total social costs.

- Discovery is one practice that helps in this regard: by bringing the beliefs of the plaintiff and defendant closer.

Incentives to Sue

- Consider the unilateral care model with a strict liability rule.

- There is incentive misalignment to file suits when there are litigation costs.

- If victims file the suit, we know that injurer will take optimal precaution.

$$\text{social costs} = x^* + p(x^*) \cdot (D + C_p + C_d)$$

  - Notice that optimal precaution is higher than in the case with no costs.

- If victim will not file the suit, then the injurer will take minimal precautions.

$$\text{social costs} = p(0) \cdot D$$

Incentives to Sue

- It is optimal to file when

$$x^* + p(x^*) \cdot (D + C_p + C_d) < p(0) \cdot D$$

$$x^* + p(x^*)(C_p + C_d) < (p(0) - p(x^*))D$$

- Private incentives to file:

$$D > C_p$$

  - Plaintiff ignores litigation costs by the defendants.

  - Ignores the (ex ante) incentives that suits create for accident prevention.

Legal Expenses

- **American Rule**: Litigants bare their own expenses regardless of the outcome of the trial.

- **English Rule**: loser pays his own and the winner's expenses.

- **Discussion**: How do different rules affect the outcomes of the legal process?

American Rule vs English Rule

- For the plaintiff:

    - Expected return from going to trial under American Rule:

    $$p \cdot \psi - C_p$$

    - Under English Rule,

    $$p \cdot \psi + (1-p)(C_d + C_p)$$

    - English is better for him if:

    $$(1-p) \cdot C_d < p \cdot C_p$$

American Rule vs English Rule

- For the defendant:
    - Expected cost from going to trial under American Rule:

$$q \cdot \psi + C_d$$

    - Under English Rule,

$$q \cdot (\psi + C_d + C_p)$$

    - English is better for him if:

$$qC_p < C_d(1 - q)$$

American vs English Rule

- Under English Rule:
  - Maximum defendant is willing to offer

  $$\bar{S}_e = q \cdot (\psi + C_d + C_p)$$

  - Minimum the plaintiff is willing to accept

  $$\underline{S}_e = p \cdot \psi + (1 - p)(C_d + C_p)$$

  - Settlement is feasible iff $\bar{S}_e \geq \underline{S}_e$.

  $$q \cdot (\psi + C_d + C_p) \geq p \cdot \psi + (1 - p)(C_d + C_p)$$

  $$(p - q) \cdot (\psi + C_d + C_p) \leq (C_d + C_p)$$

American vs English Rule

- As before, common beliefs is a sufficient condition for settlement feasibility.

- If settlement is feasible under English Rule, then feasible under American Rule.

- Trial less *likely* under American Rule.

    - Important assumption: exogenous costs C_d, C_p.

American vs English Rule

- Plaintiff files suit if sufficiently beneficial to do so.

- He finds the English rule more valuable if p is large enough:

$$p > \frac{C_d}{C_d + C_p}$$

- For low p, plaintiff files more with the American Rule.

- For high p, the opposite is true.

Rule 68

With Rule 68, a plaintiff who refuses a defendant's settlement offer and then obtains a judgment not more favorable than the offer must pay the defendant's costs.

- Model:
  - Noise recovery at trial: ψ is random with cdf F. (Plaintiff and defendant agree on this distribution.)

- Plaintiff expected value:

$$\underline{S}(S) = p\bar{\psi} - C_p - pC_d\Pr(\psi < S)$$

- Defendants cost:

$$\bar{S}(S) = q\bar{\psi} + C_d - pC_d\Pr(\psi < S)$$

Rule 68

- Is there an S such that $\underline{S}(S) \leq \bar{S}(S)$?

$$\underline{S}(S) - \bar{S}(S) = (p - q)\bar{\psi} - (p - q)C_d \Pr(\psi < S) - (C_p + C_d)$$
$$= (p - q)\bar{\psi} - (p - q)C_d F(S) - (C_p + C_d)$$

- How does this compares with the condition of the original optimism model?

Contingent Fees

- How plaintiff and lawyers split costs can also affect the outcome of litigation.

  - Fixed fee: flat hourly wage.
  - Contingent fee: lawyer covers costs but gets a share b of recovery.

- Contingent fees are common in some settings (like tort litigation).

- Illegal in certain countries.

- What are the benefits and drawbacks?

Contingent Fees

- Benefits:
    - Moral hazard.
    - Cash constraints.
    - Risk aversion.

- Drawbacks:
    - Barratry.

Contingent Fees and Settlement

- Originally, Plaintiff wants to settle if $S \geq p\psi - C_p$.

- With a contingent fee, Plaintiff wants to settle if $(1-b)S > (1-b)p\psi$. Trial happens too often.

- With a contingent fee, layer wants to settle if: $bS > pb\psi - C_p$. Settlement happens too often.

Frivolous Suits