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Rethinking Optimality in Tort Litigation: The Promise of Reverse Cost-Shifting

*Jonathan Fischbach & Michael Fischbach**

I. INTRODUCTION

Of all the known methods of redressing grievances and settling disputes—pitched battle, rioting, dueling, mediating, flipping a coin, suing—only the latter has steadily won the day in the United States.

- Jethro K. Lieberman, *The Litigious Society*¹

Over the past two decades, policymakers sought to stem the destructive social effects of the “litigation explosion”² by developing alternatives to the familiar “American Rule” of fee-shifting. Fee-shifting rules offered a promising avenue of reform. Prevailing economic wisdom held that parties weighed the anticipated benefits and costs of litigating when determining whether to settle or go to court.³ Hence, rules that shifted liability for attorneys’ fees between parties invariably influenced litigation patterns. This power of fee-shifting rules to alter litigation behavior was manifest in the Congressional practice of attaching fee-shifting provisions to statutes establishing important federal rights.⁴ In recent times, state politicians have also hoisted the banner of reform, experimenting with similar rules that shift fees to the “prevailing party”

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1. JETHRO K. LIEBERMAN, *THE LITIGIOUS SOCIETY* xi (1981)

2. See generally WALTER K. OLSON, *THE LITIGATION EXPLOSION: WHAT HAPPENED WHEN AMERICA UNLEASHED THE LAWSUIT* 152 (1991).

3. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 501-02 (1991); Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067 (1989).

4. See, e.g., 2 U.S.C. § 396 (1969); 2 U.S.C. § 1219(3)(d) (1969); 5 U.S.C. § 552b(i) (1976); 10 U.S.C. § 1089(f)(2) (1976); 12 U.S.C. § 1701q-1(f) (1959).

in certain classes of civil disputes.⁵

The objective of state legislators was to develop a “hybrid” fee-shifting rule that eliminated the major flaws of the two dominant fee-shifting paradigms: the American Rule and the British Rule.⁶ Critics argued that the American Rule, which holds each party responsible for its own legal costs regardless of the outcome, offered few disincentives for filing frivolous lawsuits. The British Rule, which requires the losing party in a civil litigation to pay the winning party’s attorney’s fees, was disparaged for discouraging plaintiffs with small but meritorious claims from pursuing redress in the courts.

However, two recent trends have impeded the success of efforts to develop a hybrid fee-shifting scheme by combining elements of both the American and British Rules. First, legislators in many states, insensitive to the divergent aims of state tort litigation and cases to enforce federal statutory rights, have imported boilerplate fee-shifting language from federal statutes into lawsuits governing state litigation practices. The insertion of federal fee-shifting provisions into state statutes has introduced uncertainty into the calculation and awarding of attorney’s fees, and imposed unwarranted “settlement surpluses” for plaintiffs resolving their grievances prior to trial.⁷

The failure of state legislators to formulate fee-shifting rules with

5. In theory, fee-shifting is not the only means of manipulating the volume of tort litigation. Most states provide common law remedies for filing frivolous lawsuits through the torts of malicious civil prosecution and abuse of process, *see generally* W. PAGE KEETON et al., *THE LAW OF TORTS* 889-96 (5th ed. 1984), and all states enforce the analogue of Rule 11 of the Federal Rules of Civil Procedure. *See* Gerald F. Hess, *Rule 11 Practice in Federal and State Court: An Empirical, Comparative Study*, 75 MARQ. L. REV. 313 (1992). Finally, some states recognize an inherent power of the court to provide limited exceptions to the American Rule. *See* *Chambers v. NASCO, Inc.*, 501 U.S. 32 (1991). However, none of these mechanisms are a proper surrogate for a fee-shifting rule with general application in civil cases. An action for malicious prosecution or abuse of process is available only if a victorious defendant can prove that the plaintiff litigated maliciously or with an ulterior motive, a prohibitively difficult burden to satisfy. *See* Scott S. Partridge et al., *A Complaint Based on Rumors: Countering Frivolous Litigation*, 31 LOY. L. REV. 221, 250 (1987). Civil procedure scholars have pronounced Rule 11 “functionally dead” in the wake of recent revisions, *see* Cynthia A. Leiferman, *The 1993 Rule 11 Amendments: The Transformation of the Venomous Viper into the Toothless Tiger?*, 29 TORT & INS. L.J. 497, 498 (1994), and the states that permit judges to use inherent powers to deviate from the American Rule sharply restrict the exercise of this authority. Even in their heyday, these civil remedies only deterred patently meritless litigation. *See, e.g.*, *Crowley v. Katleman*, 881 P.2d 1083, 1094-95 (Cal. 1994); *In re Estate of Keeven*, 882 P.2d 457, 465 (Idaho Ct. App. 1994); *Hearity v. Iowa Dist. Court*, 440 N.W.2d 860, 863 (Iowa 1989); *Goodover v. Lindey’s Inc.*, 843 P.2d 765, 775-76 (Mont. 1992); *Lannon v. Lee Conner Realty Corp.*, 385 S.E.2d 380, 383 (Va. 1989).

6. *See* Robert V. Percival & Geoffrey P. Miller, *The Role of Attorney Fee Shifting in Public Interest Litigation*, LAW & CONTEMP. PROBS., Winter 1984, at 233 (describing the history and theory of fee-shifting).

7. *See* Keith N. Hylton, *Fee Shifting and Incentives to Comply with the Law*, 46 VAND. L. REV. 1069, 1084-85 (1993) (noting that bluffing by parties trying to capture a larger portion of the settlement surplus can lead to negotiation failures) (hereinafter Hylton I).

predictable, even-handed application sparked a second disturbing trend: statutory interference with judicial processes to limit or preclude damage recovery by tort victims. In recent years, commercial defendants have exerted substantial pressure on politicians for litigation relief in the form of caps on compensatory and punitive damage awards⁸ and broad grants of legal immunity.⁹

Such initiatives introduce unseemly inequities in the judicial process. If two plaintiffs suffer severe injuries of equal magnitude, their available remedies should not differ simply because one defendant is a doctor defending a medical malpractice suit and the other a wealthy car owner in a common negligence action. Even with respect to punitive damage awards (among the heavily criticized features of the tort system) the notion that industries with political capital can statutorily evade remedies designed to deter outrageous conduct is unsettling. This politicization of the remedial process creates an appearance of insensitivity toward injured plaintiffs and threatens to produce a patchwork remedial scheme across the spectrum of tortious injury with no principled basis in common law or common experience.

The reality, however, is that doctors, gun manufacturers, and other common tort defendants will continue to flex their political muscle and employ brinkmanship tactics¹⁰ until the tort system demonstrates its capacity to consistently correlate actual outcomes with perceived legal merit. This Article adopts the premise that fee-shifting rules remain the most reliable means of inducing such reform across the tort system as a whole. Specifically, this article proposes that the Reverse-Cost Shifting (“RCS”) Rule¹¹ provides a unique incentive structure that holds the greatest promise for soothing the social tremors of the litigation explosion.

This thesis is presented in six parts. Part II briefly examines the ideal features of a hybrid fee-shifting rule. Part III discusses the importance of fee-shifting notwithstanding the views of some scholars that the ill effects of the “litigation explosion” are overblown. Part IV presents the American Rule and the British Rule and illustrates how each rule in its purest form diverges from the ideal. Part V surveys prior efforts of state legislators to merge elements of the two original rules into a hybrid fee-

8. See Meredith Matheson Thoms, Comment, *Punitive Damages in Texas: Examining the Need for a Split-Recovery Statute*, 35 ST. MARY'S L.J. 207, 208 (2003).

9. See Carl Hulse, *Senate Rejects Effort to Protect Gun Makers and Dealers*, N.Y. TIMES, Mar. 2, 2004, at A1.

10. See Frank J. Vandall, *Constricting Products Liability: Reforms in Theory and Procedure*, 48 VILL. L. REV. 843, 858 (2003).

11. Ephraim Fischbach & William McLauchlan, *Reverse-Cost Shifting: A New Proposal for Allocating Legal Expenses*, 32 J. MARSHALL L. REV. 35 (1998).

shifting scheme and analyzes the consequences of their misguided incorporation of federal fee-shifting language into state law. Finally, Part VI reintroduces the Reverse-Cost Shifting (RCS) Rule, and empirically demonstrates the advantages of this Rule using a game theory model.

II. THE ELEMENTS OF AN IDEAL FEE-SHIFTING RULE

On a micro-judicial level, the function of tort litigation is to restore both parties as nearly as possible to the position they occupied prior to the defendant's violation of legal norms.¹² The parties operate under the legal fiction that the defendant improperly benefited from his tortious behavior at the plaintiff's expense and is, therefore, liable for monetary damages sufficient to compensate the plaintiff for her resulting injuries. The ideal fee-shifting rule would encourage every wronged plaintiff to pursue an appropriate remedy no matter how small the claim but ensure that plaintiffs do not extract a financial windfall that exceeds the magnitude of their injuries.

As a rule, protracted litigation imposes financial and emotional burdens that move both parties further from their pre-incident positions as the trial progresses. Hence, an ideal fee-shifting rule would also minimize the "transaction costs" of dispute resolution by providing both parties with *equally* strong incentives to agree on an appropriate remedy outside of court, or alternatively, to settle at an early stage in the litigation. However, many hybrid fee-shifting rules diverge from this ideal by imposing "one-way" fee shifts to prevailing plaintiffs only, thereby encouraging plaintiffs to file questionable lawsuits and discouraging them from settling for an amount that fairly reflects their injuries.¹³

The structure of an ideal fee-shifting rule is also informed by macro-level concerns, including the efficiency of the judicial process, incentives to conform behavior to legal rules, and the secondary social effects of litigious behavior. If injured plaintiffs with small damage claims are systematically deterred from prosecuting those claims (particularly when they are not amenable to class disposition), tortfeasors have reduced incentives to comply with legal mandates. The efficiency of the judicial process is also a function of how parties react to uncertainty in legal rules—a problem endemic to any system of administering justice. As

12. Randall R. Bovbjerg et al., *Valuing Life and Limb in Tort: Scheduling "Pain and Suffering,"* 83 NW. U. L. REV. 908, 909-10 (1989) ("There is universal agreement that the compensatory goal of tort law requires making the successful plaintiff 'whole. . . .'").

13. See Susan M. Olson, *How Much Access to Justice from State "Equal Access to Justice Acts"?*, 71 CHI.-KENT L. REV. 547, 556-57 (1995).

discussed below, the American Rule, the British Rule and prevalent hybrids of the two rules encourage parties to “litigate to the hilt” in the absence of clear, controlling legal precedent. While such behavior is beneficial if it contributes to development in nascent areas of the law, its utility is limited in tort. Consequently, an ideal fee-shifting rule would discourage parties from exploiting uncertainty in the law through pitched legal battle, and promote extra-judicial means of dispute resolution.

Finally, the social costs of America’s litigious impulse—which range from playgrounds stripped of equipment to exorbitant medical care costs¹⁴—are a direct consequence of America’s preference for resolving tort cases in court.¹⁵ A fee-shifting rule that discourages parties from defaulting to the courts as an arbiter of civil disputes will significantly alleviate the forces that artificially inflate the price and decrease the availability of commodities that contribute to the quality and convenience of everyday life.

These macro- and micro-level fee-shifting ideals can be distilled into a single principle: the ideal fee-shifting rule is one that tilts the litigation “playing field” along a single axis—the axis of merit. It would not unduly discourage the litigation of small claims but would discourage plaintiffs from carrying weak claims to a jury. It would reduce the potential for irrational jury verdicts or excessive awards by imposing substantial financial risk on parties who decline to settle their cases before judgment. In short, it would instigate a sea change in the administration of the tort system by replacing litigation with settlement as the primary remedial avenue for plaintiffs.

III. FEE-SHIFTING AS A MEANS OF CONTAINING THE “VERDICT EXPLOSION”

A sizeable volume of scholarly work empirically challenges the magnitude of the litigation explosion, concluding that the volume of cases litigated today does not diverge substantially from earlier periods.¹⁶ Without commenting on the validity of this research, it suffices here to note that the pernicious “tort tax” is not solely a function of the *number* of cases litigated (i.e., the “litigation explosion”) but is also influenced by the unmistakable trend of increasing jury awards in cases that are

14. See Stuart Taylor Jr. & Evan Thomas, *Civil Wars*, NEWSWEEK, Dec. 15, 2003, at 34.

15. The rising cost of consumer goods and services attributable to litigious behavior is commonly referred to as a “tort tax.” See PETER W. HUBER, *LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES* 4, 11 (1988).

16. See Rex R. Perschbacher & Debra Lynn Bassett, *The End of Law*, 84 B.U. L. REV. 1, 2, 5 n.5-6 (2004); Marc Galanter & Mia Cahill, *Most Cases Settle: Judicial Promotion and Regulation of Settlements*, 46 STAN. L. REV. 1339, 1339-40 (1994).

litigated to a verdict (termed here the “verdict explosion”).¹⁷

Theoretically, if the market price for “litigated goods” reflects each vendor’s individual experiences, contemporary trends toward settlement and alternative dispute resolution might well reduce the costs of these goods in aggregate. The sting of large jury verdicts, however, is primarily absorbed by insurance companies, not individual providers of goods and services.¹⁸ As a rule, insurance companies set their premiums using risk calculations that incorporate data from their own experiences as well as those of other participants in the industry.¹⁹ If, hypothetically, plaintiffs in two medical malpractice cases each receive jury verdicts of \$20 million, medical malpractice premiums will soar even if ninety-eight other malpractice cases settle for reasonable sums.²⁰ Commonsense business principles dictate that insurance companies conducting the standard “weighted average” calculation account for the rare cases that generate large verdicts. The result is that a “verdict explosion”—or small minority of cases generating enormous jury awards—can induce a tort tax regardless of whether overall trial frequency rises to the level of a “litigation explosion.”

Any tort reform strategy aiming to reduce the tort tax must therefore address litigated cases that produce large jury verdicts, and the concomitant trend of defendants settling with plaintiffs for unreasonably high sums to avert such results. Both trends exert economic pressure on insurance companies that ultimately result in higher premiums. Two conceivable ways of reducing the resulting tort tax is to place statutory caps on jury awards, or establish tort immunity for defendants in particular industries. While such measures may reduce insurance costs by lowering and stabilizing jury verdicts in these outlying jury cases, they raise the fundamental fairness concerns outlined above and lead to irresponsible behavior.

17. This trend is highlighted in a line of recent Supreme Court cases addressing the Due Process and Eighth Amendment implications of excessive verdicts. *See* *State Farm Mut. Auto Ins. Co. v. Campbell*, 123 S. Ct. 1513 (2003); *Cooper Indus. v. Leatherman Tool Group, Inc.*, 121 S. Ct. 1678 (2001); *BMW of N. Am., Inc. v. Gore*, 116 S. Ct. 1589 (1996); *see also* Michael Rustad & Thomas Koenig, *The Historical Continuity of Punitive Damages Awards: Reforming the Tort Reformers*, 42 AM. U. L. REV. 1269, 1275-76 (1993).

18. *See* William T. Barker, *Lobbying and the American Law Institute: The Example of Insurance Defense*, 26 HOFSTRA L. REV. 573, 574 (1998); John W. Wade, *Should Joint and Several Liability of Multiple Tortfeasors be Abolished?*, 10 AM. J. TRIAL ADVOC. 193, 209 (1986).

19. *See* Frank A. Sloan & Mahmud Hassan, *Equity and Accuracy in Medical Malpractice Insurance Pricing*, 9 J. HEALTH ECON. 289, 292-93 (1990) (discussing risk classification methods used by medical malpractice insurers); Herbert I. Weisberg & Thomas J. Tomberlin, *A Statistical Perspective on Actuarial Methods for Estimating Pure Premiums from Cross-Classified Data*, 49 J. RISK & INS. 539 (1982).

20. Sloan & Hassan, *supra* note 19, at 290 (“Policyholders may be homogenous; yet losses may be concentrated if the adverse outcome has a low probability but high associated loss.”).

Implementing a fee-shifting rule that creates strong incentives to settle in every case can also modify an insurer's risk calculus. Such a rule offers promise for reform by walking the delicate tightrope between fairness to plaintiffs and antipathy toward tort taxes by preserving the *option* to litigate, but making this choice sufficiently unattractive so that parties will choose of their own accord to settle. In the final analysis, it is difficult, if not impossible, for an insurance company to predict *ex ante* what types of cases will settle and which will be litigated to an adverse verdict. But if a fee-shifting rule with universal application discourages parties from litigating *any* case to a verdict, insurance companies will face reduced risks that "outlier" cases will yield high jury awards, or that insured defendants would be systematically coerced into settling with plaintiffs on unfavorable terms. Insurance companies will likely respond by lowering premiums, thereby reducing the problematic tort tax.

IV. THE TWO DOMINANT FEE-SHIFTING PARADIGMS

A. *The American Rule*

Over the past two centuries, civil litigation emerged as a popular method of dispute resolution,²¹ a trend that American courts nurtured through their development of the common law.²² In the early twentieth century, the Supreme Court stressed the importance of preserving access to courts as an avenue of redress for injured parties who might otherwise take the law into their own hands: "The right to sue and defend in the courts is the alternative of force. In an organized society it is the right conservative of all other rights, and lies at the foundation of orderly government. It is one of the highest and most essential privileges of citizenship. . . ."²³ To guarantee the availability of judicial process to plaintiffs with limited economic means, nineteenth-century American judges rejected the fee-shifting jurisprudence of their colonial predecessors, interpreting state statutes to preclude the recovery of attorneys' fees by victorious parties.²⁴ These practices culminated in an

21. One author observes that "[al]though litigation has not routed all other forms of fight, it is gaining public favor as the legitimate and most effective means of seeking and winning one's just desserts." LIEBERMAN, *supra* note 1.

22. Legislators and judges in many states remain vigilant in their efforts to preserve the American Rule. *See, e.g.*, *Crowley v. Katleman*, 881 P.2d 1083, 1094-95 (Cal. 1994); *In re Estate of Keeven*, 882 P.2d 457, 465 (Idaho Ct. App. 1994); *Hearity v. Iowa Dist. Court*, 440 N.W.2d 860, 863 (Iowa 1989); *Goodover v. Lindey's Inc.*, 843 P.2d 765, 775-76 (Mont. 1992); *Lannon v. Lee Conner Realty Corp.*, 385 S.E.2d 380, 383 (Va. 1989).

23. *Chambers v. Baltimore & Ohio R.R.*, 207 U.S. 142, 148 (1907).

24. *See* Arthur L. Leubsdorf, *Toward a History of the American Rule on Attorney Fee Recovery*, LAW & CONTEMP. PROBS., Winter 1984, at 9, 10.

“American Rule” of fee-shifting, a term coined by Arthur Goodhart to refer to the practice of holding each party to a civil litigation responsible for its own lawyer’s fees, and freeing the losing party from any obligation to reimburse the legal costs of the winner.²⁵ In the twentieth century,²⁶ this rule embedded itself in the legal process to such a significant degree that on several occasions the United States Supreme Court proclaimed its unwillingness to create common law inroads into the American Rule in the absence of state or federal legislation.²⁷

1. The policies underlying a “pay your own way” system

While the American Rule is unique among Western legal systems in dissociating the obligation to pay legal expenses from trial outcomes,²⁸ sound policies underlie the institutional reluctance to transfer responsibility for attorneys’ fees between litigating parties. Judge Cardozo and other jurists theorized that unless one party brought or defended a lawsuit in bad faith, the equities between the litigants would not be so unbalanced as to justify shifting attorneys’ fees that are necessarily incident to establishing legal rights. According to Judge Cardozo,

[s]ome of the losses that are incidental to the establishment of rights and the redress of wrongs through the processes of courts should be allowed, as a matter of social engineering, to lie where they fall. Very likely, heavier burdens should be imposed where there is evidence of bad faith or mere dogged perversity.²⁹

More pragmatically, the American tort system is designed to serve

25. Arthur Goodhart, *Costs*, 38 YALE L.J. 849 (1929); Thomas D. Rowe, Jr., *The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651, 651 (1982) [hereinafter Rowe I].

26. See Carl Tobias, *Civil Rights Conundrum*, 26 GA. L. REV. 901, 904-05 (1992). See generally OLSON, *supra* note 2.

27. See, e.g., *Alyeska Pipeline Co. v. Wilderness Society*, 421 U.S. 240, 270 (1975) (“We do not purport to assess the merits or demerits of the ‘American Rule’ with respect to the allowance of attorneys’ fees. It has been criticized in recent years, and courts have been urged to find exceptions to it. . . . But the rule followed in our courts with respect to attorneys’ fees has survived. It is deeply rooted in our history and in congressional policy; and it is not for us to invade the legislature’s province by redistributing litigation costs. . . .”).

28. Outside the United States, only Japan follows the American practice of systematically assigning each party responsibility for its own legal fees for most classes of civil cases. One significant exception is tort suits, where the defendant is required to pay the legal expenses of a prevailing plaintiff. See Rowe I, *supra* note 25, at 651 n.1.

29. Letter from Benjamin N. Cardozo to H.H. Nordlinger, *quoted in* G. HELLMAN, BENJAMIN N. CARDOZO: AMERICAN JUDGE 150 (1940).

the dual function of compensating plaintiffs for their individual injuries and, on a broader scale, to limit the incidence of high-risk behavior.³⁰ To satisfy both objectives, the legal system must tolerate some fruitless claims to promote the vigilance of potential tortfeasors engaged in high-risk activities.³¹ For many plaintiffs, particularly those seeking damages that are modest relative to their attorney's fees, the prospect of also paying their opponent's legal expenses if they lose creates a significant disincentive to bringing suit. Under such a regime, where the normative value of particular legal rights outweighs a plaintiff's financial interest in their preservation (such as the right to exclude strangers from one's property), such rights might atrophy from lack of enforcement.

Finally, the American Rule has value despite the claims of some critics that it defeats the tort system's avowed goal of "making the victim whole," or placing a victorious plaintiff in the same financial position they occupied prior to the tortious event: "Undeniably, the American Rule's effect of reducing a successful plaintiff's recovery by the amount of his lawyer's fee conflicts with the make-whole idea underlying much of the law of remedies."³² Indeed, conceptualizing the costs of bringing or defending a lawsuit as a "legal injury" akin to the physical or emotional injuries resulting from tortious conduct casts doubt on the wisdom of a fee-shifting rule that permits recovery of one but not the other. A 1925 report of the Judicial Council of Massachusetts reduced the argument to a single question: "On what principle of justice can a plaintiff wrongfully run down on a public highway recover his doctor's bill but not his lawyer's bill?"³³

However, the American legal system has never accorded a plaintiff's physical injuries and legal fees equivalent status.³⁴ Indeed, "our system does not regard bringing (or, for that matter, defending) a losing case—without more—as the infliction of a legal wrong."³⁵ Precisely why attorneys' fees occupy an unequal position relative to other forms of tortious injury is a matter of speculation. The high value that Americans attach to litigation—both as a means of deterring injurious behavior and resolving civil disputes—indicates that citizens may regard litigation

30. See Gregory A. Hicks, *Statutory Damage Caps are an Incomplete Reform: A Proposal for Attorney Fee Shifting in Tort Actions*, 49 LA. L. REV. 763, 774-75 (1989).

31. See Gary T. Schwartz, *Mixed Theories of Tort Law: Affirming Both Deterrence and Corrective Justice*, 75 TEX. L. REV. 1801, 1831 (1997).

32. Rowe I, *supra* note 25, at 657.

33. Judicial Council of Massachusetts, First Report, 11 MASS. L.Q. 7, 64 (1925).

34. The United States Supreme Court has observed in the administrative law context that "[m]ere litigation expense, even substantial and unrecoverable cost, does not constitute irreparable injury." *Renegotiation Bd. v. Bannerkraft Clothing Co.*, 415 U.S. 1, 24 (1974).

35. Rowe I, *supra* note 25, at 659. See Philip J. Mause, *Winner Takes All: A Re-Examination of the Indemnity System*, 55 IOWA L. REV. 26, 30 (1969).

expenses as necessarily incident to the exercise of a valuable right, rather than as a source of additional financial injury. Perhaps Americans view attorneys' fees differently due to the inherent avoidability of legal expenditures. To extend the hypothetical offered by the Judicial Council of Massachusetts, a plaintiff is powerless to prevent the medical injuries that result from being run over in the street, but in many cases could limit or eliminate litigation expenses through non-adversarial strategies such as settlement. This conception of litigation is consistent with the high premium that citizens place on the *option* to litigate but suggests that a trial with all the bells and whistles should be a last resort for resolving civil disputes.

One final explanation for the disparate treatment of physical/emotional injury and attorneys' fees within the tort system is the similarity of legal costs to consequential economic losses that are denied as a matter of policy to tort plaintiffs. As the First Circuit observed in *Barber Lines A/S v. M/V Donau Marau*: "[M]any of the 'financially injured' will find it easier than the 'physically injured' to arrange for cheaper, alternative compensation. The typical "financial" plaintiff is likely to . . . buy [] insurance, and . . . may well be able to arrange for 'first party' loss compensation for foreseeable financial harm."³⁶ While this theory fails to explain the application of the American Rule in legal regimes that permit the recovery of pure economic loss, it is worth noting that legislative exceptions to the American Rule are far more prevalent outside the tort system.³⁷

2. Drawbacks of the American Rule

Particularly within the last twenty years, the American Rule has been denounced as inefficient and unfair. Critics assert that parties with only their own legal expenses to consider are encouraged to engage in wasteful litigation.³⁸ Congressional opposition to the American Rule reached a fever pitch in 1994, as the House of Representatives considered the wholesale adoption of a British-style, "loser pays" fee-shifting system as a component of the "Contract with America" legislative program.³⁹ The Bush Administration's Council on

36. 764 F.2d 50, 54 (1st Cir. 1985).

37. See *infra* Part IV.A.2.

38. Lorraine Wright Feuerstein, Comment, *Two-Way Fee Shifting on Summary Judgment or Dismissal: An Equitable Deterrent to Unmeritorious Lawsuits*, 23 PEPP. L. REV. 125, 128 (1995) ("The American rule provides no deterrent to groundless litigation. In fact it invites spurious claims.") (citing further scholarly criticism of the American rule).

39. Thomas D. Rowe, *Indemnity or Compensation? The Contract with America, Loser-Pays Attorney Fee Shifting, and a One-Way Alternative*, 37 WASHBURN L.J. 317, 319 (1998) [hereinafter

Competitiveness, led by Vice President Dan Quayle, defended the proposal, arguing that “[b]ecause the losing party will be obligated to pay the winner’s fees, this approach will encourage litigants to evaluate carefully the merits of their cases before initiating a frivolous claim or adopting a spurious defense.”⁴⁰

But even as the American Rule is impugned for failing to deter non-meritorious litigation practices, it is simultaneously criticized for *over*-detering lawsuits by plaintiffs bringing small claims that are swallowed by attorneys’ fees: “Even though the American Rule may encourage the filing of claims that have no basis in law or fact, some legitimate claims may still remain unredressed when the cost to litigate exceeds the possible recovery.”⁴¹ While in some cases an attorney will represent the plaintiff on a contingency fee basis, it is unlikely that lawyers will invest their time in cases with a low potential payoff.

Consequently, individuals are discouraged from using the courts to vindicate clear legal entitlements in two types of cases. First, injured plaintiffs are deterred from filing claims when the economic magnitude of their injury is small relative to their anticipated legal expenses, particularly when they are the sole victim of the tortfeasor’s conduct. For example, failure to repay a small debt or to adhere to a contract after the other party has performed may not give rise to a viable lawsuit. States typically restrict the jurisdiction of small claims courts to trivial sums,⁴² leaving a sizable gap between the jurisdictional ceiling of these courts and the magnitude of financial injury that economically justifies litigating in a court of general jurisdiction.⁴³ Cases slipping between the cracks of small claims courts and courts of general jurisdiction might become cause for alarm if they reflected systematic absorption of injury damages by victims. However, the sporadic incidence of sharp practices imposes fairly minor costs due to the small amounts at stake and the availability of extra-judicial means of inducing compliance (including threats to reputation, damage to credit history, etc.).

Of greater social concern are cases in which the benefits of litigating

Rowe II].

40. Dan Quayle, *Agenda for Civil Justice Reform in America*, 60 U. CIN. L. REV. 979, 1003 (1992).

41. Feuerstein, *supra* note 38, at 130-31. See also Albert A. Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CAL. L. REV. 792 (1966).

42. For example, the jurisdictional limit for small claims courts in New York is \$3,000, while small claims courts in Massachusetts only adjudicate claims of \$1500 or less. See Gerald Lebovits, *Special Procedures Apply to Enforcing Judgments in Small Claims Courts*, 71 N.Y. ST. B.J. 28 (1999) (citing Small Claims §§ 1813(a) – 1813-A(a)); Douglas L. Fox, *Damages in Massachusetts Litigation*, 2 PRACTICE AND PROCEDURE IN DAMAGES CASES § 2.16 (2003).

43. See Bruce Zucker & Monica Her, *The People’s Court Examined: A Legal and Empirical Analysis of the Small Claims Court Examined*, 37 U.S.F. L. Rev. 315, 319, 326 (2003).

far outweigh the costs but where litigation is still unattractive because the benefits take the form of a public good. This class of lawsuits can be further sub-divided into two categories. First, a defendant may inflict an injury diffused over a sufficiently large group of potential plaintiffs such that it is not in the interest of any single plaintiff to assume the financial burden of initiating legal action. Consider a nuisance case in which emissions from a factory degrade the air quality for neighboring residents.⁴⁴ The residents may possess an entitlement to clean air, but the transaction costs of overcoming collection action problems to institute legal proceedings may preclude enforcement of this entitlement. Critics of the American Rule observe that a fee-shifting rule requiring the defendant to reimburse the legal costs of a victorious plaintiff would dramatically reduce the financial obstacles to filing suit.⁴⁵ Indeed, plaintiffs with an unambiguous legal entitlement are attractive candidates for contingency fee arrangements.⁴⁶

The second sub-category of high-impact/small-recovery cases are those in which bringing suit is financially risky because liability can only be established through a change in the existing law. Professor Frank Cross observes that:

A fundamental outcome of litigation, and perhaps its greatest benefit to society, is producing precedents that define the law, affect subsequent decisions, and influence private economic behavior. However, such precedents are in many respects externalities or public goods because the litigants themselves cannot capture much of the benefit associated with a precedent that their case creates.⁴⁷

Concededly, a potential plaintiff is more likely to fight for a change in the law as a “private attorney general” outside the tort system. For

44. A. M. POLINKSY, AN INTRODUCTION TO LAW AND ECONOMICS 15 (2d ed. 1989); Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

45. Martha Pacold, Comment, *Attorneys’ Fees in Class Actions Governed by Fee-Shifting Statutes*, 68 U. CHI. L. REV. 1007, 1007 (2001) (discussing the fee-shifting methods and the calculations of attorneys’ fees where the loser must pay the prevailing party).

46. Fee-shifting schemes purporting to encourage efficient levels of litigation cannot rely on class litigation to overcome the public goods dilemma, but must create incentives for plaintiffs to sue in their individual capacity. The efficacy of class litigation is not only restrained by formidable procedural obstacles to certifying a class, see, e.g., FED. R. CIV. P. 23(a) & (b) ((detailing the manifold requirements that plaintiffs must satisfy to maintain a class action lawsuit), but in many cases “the cost of organizing the class and of overcoming free-rider problems may well [be] too high for the class to form and litigate.”); Paul H. Rubin, *Common Law and Statute Law*, 11 J. LEGAL STUD. 205, 220 (1982).

47. Frank B. Cross, *In Praise of Irrational Plaintiffs*, 86 CORNELL L. REV. 1, 2 (2000); see generally William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979).

example, the predominantly statute-based realms of civil rights, labor, tax, and regulatory behavior are prime forums for plaintiffs with proper financial incentive to fight stagnation in the law by litigating disputes that reveal pathologies in the status quo understanding of particular statutes. While the tort system may be older and less dynamic than blossoming areas of statutory law, it is also more susceptible to ossification and, therefore, in need of occasional shocks from enterprising plaintiffs. For example, Judge Cardozo's opinion in *MacPherson v. Buick Motor Co.*⁴⁸ revolutionized the field of products liability by eliminating the requirement of privity between the injured party and the manufacturer. Advocates of fee-shifting would denounce the American Rule by emphasizing the *ex ante* unattractiveness of MacPherson's position. Not only did he assume substantial financial risk by bringing suit as a party with no privity to the manufacturer, but he must also have known that he could only prevail by accomplishing a change in the law at the end of a costly appeals process.⁴⁹

While *MacPherson* and other groundbreaking tort cases⁵⁰ illustrate that the American Rule does not systematically chill landmark tort litigation, the costs of undertaking trials and appeals are higher today than they were when such cases as *MacPherson* and *Escola* were litigated.⁵¹ Presuming that the social benefits of instigating shocks to the tort system generally outweigh the costs to the individual litigant,⁵² the American Rule's failure to reward risk-taking plaintiffs inflicts costs on society. These consequences are exacerbated in the tort system, where the private nature of injuries deters special interests and other organizational plaintiffs from subsidizing the costs of tort lawsuits in the public interest.

A final disadvantage of the American Rule is its unequal treatment of

48. 111 N.E. 1050 (N.Y. 1916).

49. While some commentators invoke "repeat player" theories to explain litigation behavior that appears irrational within the context of a single case, plaintiffs like MacPherson (or even their attorneys) are unlikely repeat players because they have little to gain in future litigation. Repeat players are predominantly tort defendants, who may act irrationally in a small cluster of cases in order to establish favorable precedent that pre-empts future lawsuits at their expense. See Cross, *supra* note 47, at 9.

50. See, e.g., *Li v. Yellow Cab*, 532 P.2d 1226 (Cal. 1975) (rejecting the existing theory of contributory negligence and adopting a pure comparative negligence standard); *Escola v. Coca Cola Bottling Co.*, 150 P.2d 436 (Cal. 1944) (Traynor, J., concurring) (advocating for a rule of strict liability for manufacturers to replace California's negligence-based regime).

51. See, e.g., Meade W. Mitchell, *Discovery Abuse and a Proposed Reform: Mandatory Disclosure*, 62 Miss. L. J. 743, 750 (1993) (observing that modern discovery practices have dramatically increased the costs of litigation).

52. This may not always be the case. In *Dillon v. Legg*, 441 P.2d 912 (Cal. 1968), the California Supreme Court controversially held that a bystander who witnesses a close relative being injured can recover damages for emotional distress. Yet the vague standard established in *Dillon* was subsequently rejected by most other states. See Feuerstein, *supra* note 38, at 162.

cases with similar expected values but different relative strengths. If a case is divided into two primary components—liability and damages—the expected value of the case is equal to the product of (1) the probability of proving liability (or the percentage of liability in a pure comparative fault regime), and (2) the reasonably calculated damages.⁵³ From an efficiency standpoint, cases with a comparable expected value should yield similar compensation for plaintiffs. Consider the following two cases: (1) A plaintiff claims he suffered whiplash from an automobile accident in which the defendant was clearly at fault; (2) a plaintiff claims that she fell out of bed and broke her legs because her doctor administered an excessive dose of antibiotic.⁵⁴

In the first instance, the liability component of the case is strong, but damages are more uncertain. Conversely, liability is more difficult to prove in the second case, but the damages are easily ascertainable. Because the American Rule does not penalize parties who litigate to the hilt, it encourages plaintiffs who can overcome summary judgment to argue exhaustively (at significant expense to both parties) the flimsier damages claim once they have reached the jury. By contrast, plaintiffs with a concrete damages claim but a weaker case for liability is unlikely to obtain a settlement offer that approximates their damages since the defendants will often channel their resources into a fight for dismissal at the summary judgment stage. This horizontal inequality between cases with similar expected values illustrates the inefficiency that plagues the tort system under the American Rule. In a world without transaction costs, a defendant would expend scarce financial resources to offer partial compensation to “weak-liability plaintiffs” (appropriately discounted to reflect uncertain liability). “Strong-liability plaintiffs” would similarly accept an offer of compensation that accurately reflects their injuries, without expending resources to finance a roll of the dice with a jury.

B. The British Rule

Proposals to modify the American Rule invariably incorporate elements of the “British” or “loser pays” rule. In its purest form, the British Rule requires the losing party in a civil litigation to pay the winning party’s attorney’s fees.⁵⁵ This species of attorney-fee

53. See Stephen J. Spurr & Walter O. Simmons, *Medical Malpractice in Michigan: 21 An Economic Analysis*, J. HEALTH POL. POL’Y & L. 315, 333 (1996).

54. See *Brune v. Belinkoff*, 235 N.E.2d 793 (Mass. 1968).

55. Werner Pfennigstorf, *The European Experience with Attorney Fee Shifting*, LAW & CONTEMP. PROBS., Winter 1984, at 44 (1984).

reimbursement is known as “two-way” fee-shifting because costs can flow either from the defendant to the plaintiff or vice versa depending on the outcome of the case.⁵⁶ The pillar of the British Rule is the shift of attorneys’ fees under a system of “general indemnification.”⁵⁷ Indemnification is the equivalent of strict or no-fault liability in tort; the party adjudged to have lost the case is responsible for the winner’s attorney’s fees regardless of the margin of victory or the objective merit of the loser’s case.⁵⁸

While the British Rule offers certain efficiency advantages,⁵⁹ the rule in its unadulterated state is incompatible with the American conception of litigation as an important correlate of justice. Citizens in the United States place a high premium on the option to go to court, and the deterrent effect of the British Rule undoubtedly closes the courthouse doors to many low-income parties. Some laud the British Rule as a corrective mechanism for the American Rule’s over-deterrence of small claims in which the operative legal rule substantially favors the potential plaintiff.⁶⁰ However, while the British Rule might discourage frivolous litigation when legal standards are clear, tort claims are inherently fact-sensitive and rarely susceptible to predictable outcomes under clear unambiguous legal rules.⁶¹ As soon as legal uncertainty is introduced into a dispute, parties who are risk-averse or have shallow pockets may be hesitant to expose themselves to substantial fee-shifts at the close of litigation. The British Rule is particularly troubling because it imposes this chilling effect disproportionately on private litigants opposing individually wealthy or commercial defendants who rapidly accumulate legal expenses.⁶²

Finally, a fee-shifting rule predicated on no-fault indemnification has a punitive ring that is inconsistent with the exalted status of litigation in American society. Professor Thomas Rowe remarks that “[p]ractices in this country . . . leave room for the feeling that losers will often not have been unreasonable or unjustified in insisting on litigation.”⁶³ Judge

56. Robin Stanley, Note, *Buckhannon Board and Care Home, Inc. v. West Virginia Department of Health and Human Resources: To the Prevailing Party Goes the Spoils . . . and the Attorney’s Fees!*, 36 AKRON L. REV. 363, 368 & n.30 (2003).

57. Rowe I, *supra* note 25, at 655.

58. See Rowe II, *supra* note 39, at 321-22.

59. See 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, 1118 (1991).

60. See *id.*

61. See Keith N. Hylton, *Fee Shifting and the Predictability of Law*, 71 CHI.-KENT L. REV. 427, 437-38 (1995) (hereinafter Hylton II).

62. See Gregory E. Maggs & Michael D. Weiss, *Progress on Attorney’s Fees: Expanding the “Loser Pays” Rule In Texas*, 30 HOUS. L. REV. 1915, 1927 (1994).

63. Rowe I, *supra* note 25, at 655-56.

Cardozo offered this first-hand perspective: “I have seen enough of the judicial process to know its imperfections. I would not lay too heavy a burden upon the unsuccessful litigant.”⁶⁴

V. ECHOES OF THE BRITISH RULE IN AMERICAN REFORM

A. *State and Federal Modification of the American Rule*

While a wholesale adoption of the British Rule is infeasible for the American judicial process, Congress and various states have morphed the American and British Rules into hybrid fee-shifting schemes for use in certain state and federal lawsuits.⁶⁵ Before analyzing these schemes, recall that the two primary criticisms of the American Rule are its under-deterrence of frivolous litigation tactics and its over-deterrence of plaintiffs with small but meritorious claims.⁶⁶ Generally, critics who are disillusioned by wasteful litigation will prefer one-way fee-shifting rules that transfer costs only from plaintiffs to prevailing defendants. On the other hand, those predominantly concerned about the prospects of small-claim plaintiffs advocate for statutory provisions that shift fees in the opposite direction.

The process of translating these policy objectives into concrete fee-shifting rules occurs on parallel tracks in Congress and the state legislatures. However, commentators routinely overlook the divergent objectives of federal fee-shifting rules and analogous state provisions. Legislators in Washington fashion fee-shifting provisions to encourage plaintiffs to act as private attorneys general when enforcement of the rights in question serves the public interest.⁶⁷ Federal fee-shifting provisions are accordingly designed to discourage litigation that impedes the exercise of these statutory rights.⁶⁸ Conversely, state-conceived fee-shifting rules are applied to legal subject matter that governs more individualized disputes in such common law realms as contract, tort, and

64. Cardozo quoted in HELLMAN, *supra* note 29.

65. By 1983, Congress had passed over two hundred federal statutes containing fee-shifting provisions into law. Susanne Di Pietro & Teresa W. Carns, *Alaska's English Rule: Attorney's Fee Shifting in Civil Cases*, 13 ALASKA L. REV. 33, 37(1996) (citing 3 Mary Francis Derfner & Arthur D. Wolf, *Court Awarded Attorney Fees*, table of statutes (1983)). Texas and California have legislated significant modifications to the American Rule for particular types of cases, while Alaska features a blanket fee-shifting scheme that more closely resembles the British rule than the American Rule. Feuerstein, *supra* note 38, at 133.

66. See *supra* Part IV.A.2.

67. See *Buckhannon Bd. and Care Home, Inc. v. West Virginia Dep't of Health and Human Res.*, 532 U.S. 598, 635-36 (Ginsburg, J., dissenting); Marisa L. Ugalde, *The Future of Environmental Citizen Suits After Buckhannon Board & Care Home, Inc. v. West Virginia Department of Health & Human Services*, 8 ENVTL. LAW. 589, 594-95 (2002).

68. See Di Pietro & Carns, *supra* note 65, at 37.

property.

As a policy tool designed to promote efficiency, fee-shifting rules mold to a particular sovereign's conception of optimality. In the federal system, efficiency is reached at the point where the public interest is maximized.⁶⁹ In certain statutory areas where fee-shifting provisions are common, including environmental law, consumer protection, and civil rights, the public interest may be measured in units of preservation, safety, and personal dignity, rather than dollars and cents.⁷⁰ Thus, reaching the efficient level of litigation from a public interest perspective is not accomplished by seeking to enforce legal rights at the lowest cost, but by gradually adding flesh to the bones of statutory language through repeated legal challenges.

In the state tort system, however, the salient objective is not to determine the scope of newly created rights, but to apply well-established legal rules to particular, often challenging, factual scenarios.⁷¹ In this Coasean paradigm,⁷² litigation is a transaction cost of enforcing compliance with legal rules. Because an excessive number of lawsuits artificially distorts the price of engaging in particular behavior,⁷³ the efficient level of tort litigation is the minimal level of litigation necessary to ensure full compliance with legal rules.

Given the dissimilar goals of federal and state fee-shifting rules, one would expect the malleable American and British rules to be sculpted differently by federal and state legislators. Specifically, a fee-shifting rule tailored for the tort system would impose financial penalties for bringing or defending non-meritorious claims and encourage parties to settle immediately after ascertaining the extent of the defendant's liability under the relevant legal rules. However, a fee-shifting provision in a federal statutory scheme might provide plaintiffs with incentives to

69. See Joseph K. King, Jr., *Pain and Suffering, Noneconomic Damages, and the Goals of Tort Law*, 57 SMU L. REV. 163, 180-201 (2004) (outlining general goals of the tort system).

70. See Jeffrey S. Brand, *The Second Front in the Fight for Civil Rights: The Supreme Court, Congress, and Statutory Fees*, 69 TEX. L. REV. 291, 309 (1990) (in § II.B.3, discussing the stated legislative goals of the Civil Rights Attorney's Fees Award Act of 1976).

71. See Betsy J. Grey, *The New Federalism Jurisprudence and National Tort Reform*, 59 WASH. & LEE L. REV. 475, 518-19 (2002).

72. See generally, Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 1-44 (1960).

73. See Common Sense Product Liability Legal Reform Act of 1996, H.R. 956, 104th Cong. § 2(a)(4) (1996) (vetoed) (observing that the consequence of excessive and unpredictable damage awards is that "consumers have been adversely affected through the withdrawal of products, producers, services, and service providers from the marketplace"); *Brown v. Superior Ct.*, 751 P.2d 470, 479 (Cal. 1988) (blaming the tort system for contributing to sharp increases in the price of Bendectin and DTP vaccine); HUBER, *supra* note 15, at 155-61 (asserting that strict products liability has caused stagnation in research and development in the drug, contraceptive, chemical, small aircraft, automotive, and medical industries).

litigate for the purpose of compiling a comprehensive record that enables judges to formulate reasoned constructions of the law. As discussed below, the fee-shifting rules emerging in both systems are strikingly similar, raising the possibility that state-led reforms of the American Rule sacrifice efficiency by furnishing plaintiffs with incentives to litigate that are inappropriate in tort.

B. The Result of State and Federal Fee-Shifting Experimentation: Broad Judicial Discretion Under a Pro-Prevailing Plaintiff Regime

On the federal level, Congress inserts boilerplate fee-shifting language into select statutes, reflecting a one-dimensional purpose of removing obstacles for potential plaintiffs that does not vary with the subject matter of the statutory rights created. For example, in 1974 Congress passed the Employee Retirement Income Security Act (ERISA), a law designed to regulate the private employee benefit system and, specifically, to ensure that workers received the benefits promised to them by their employers.⁷⁴ The statute grants courts the power to award attorneys' fees through language that is "broad and unconstrained":⁷⁵ "[t]he court in its discretion may allow a reasonable attorney's fee and costs of action to either party."⁷⁶ In 1976, Congress enacted the Civil Rights Attorney's Fees Awards Act,⁷⁷ which uses nearly identical language in authorizing judges to shift fees in federal civil rights actions: "The court, in its discretion, may allow the prevailing party . . . a reasonable attorney's fee as part of the costs."⁷⁸ Indeed, the Supreme Court has encouraged lower courts to develop federal common law to guide judges applying these uniform fee-shifting provisions, observing that the "fee-shifting statutes' similar language is a 'strong indication' that they are to be interpreted alike."⁷⁹

Fee-shifting statutes enacted in states such as Alaska, California, and Texas closely track their federal analogues. For instance, the Alaska Code of Civil Procedure grants judges broad discretion to award fees to victorious litigants: "Except as otherwise provided by statute, the

74. 29 U.S.C. § 1001 (1994). See BARBARA J. COLEMAN, PRIMER ON ERISA FIDUCIARY DUTIES 5 (BNA 3d ed. 1989).

75. Da-Wai Hu, Comment, *Running the Caucus-Race: Prevailing Parties and Fee Shifting under ERISA*, 67 U. CHI. L. REV. 217, 220 (2000).

76. *Id.* (citing 29 U.S.C. § 1132(g)(1) (1994)).

77. 42 U.S.C. § 1988(b) (Supp. IV 1992).

78. *Id.*

79. *Flight Attendants v. Zipes*, 491 U.S. 754, 758 n.2 (1989); see also *Hensley v. Eckerhart*, 461 U.S. 424, 433 n.7 (1983) ("The standards set forth in this opinion are generally applicable in all cases in which Congress has authorized an award of fees to a 'prevailing party.'").

supreme court [of Alaska] shall determine by rule or order what costs, if any, including attorney fees, shall be allowed the prevailing party in any case.”⁸⁰ Unlike Alaska, California has no blanket fee-shifting provision that applies to all civil actions brought in state court but enforces fee-shifting rules for specific types of controversies. In rare categories of cases, including dog-breeding disputes⁸¹ and breaches of contract for swimming pool construction,⁸² California law automatically requires the losing party to compensate the victor for her attorney’s fees. However, the majority of California’s fee-shifting rules grant broad discretion to trial judges.⁸³ Ironically, Texas’s fee-shifting rules, which most closely approximate the efficiency ideal articulated above, exclude state tort claims from their reach.⁸⁴ Nonetheless, by mandating fee-shifting in such areas as landlord-tenant disputes,⁸⁵ distribution of alcoholic beverages,⁸⁶ and city building ordinances,⁸⁷ these Texas statutes and the small minority of California laws that eliminate discretion in fee-shifting provide an important model for tort reformists.

The fee-shifting models adopted in the states contain three flaws that undermine their fairness and efficiency: (1) an implicit preference for prevailing plaintiffs over prevailing defendants, (2) broad grants of fee-shifting discretion to trial judges that result in unpredictable outcomes and collateral litigation, and (3) a tendency to improperly influence the primary behavior of future litigants.

1. Inefficiency resulting from the judicial preference for awarding fees to prevailing plaintiffs

Although the neutral language of two-way fee-shifting provisions implies that prevailing plaintiffs and defendants are equally entitled to attorneys’ fees, judges routinely interpret both state and federal fee-shifting rules as expressing a strong preference for prevailing plaintiffs. One commentator examining the Civil Rights Attorney’s Fees Awards Act observed that “despite the statutory phrases ‘in its discretion’ and ‘prevailing party,’ . . . fees are normally awarded only to prevailing plaintiffs. The effect of [section] 1988 is that prevailing plaintiffs almost

80. ALASKA R. CIV. P. 82(a)(1) (1959).

81. CAL. HEALTH & SAFETY CODE § 25989.555 (West Supp. 1995).

82. CAL. BUS. & PROF. CODE § 7168 (West Supp. 1995).

83. See RICHARD M. PEARL, CALIFORNIA ATTORNEY FEE AWARDS § 2.4 (Christopher D. Dworin ed., 2d ed. 1994).

84. See generally Maggs & Weiss, *supra* note 62.

85. TEX. PROP. CODE ANN. § 24.0062 (West Supp. 1995).

86. TEX. ALCO. BEV. CODE ANN. § 102.79 (West Supp. 1995).

87. TEX. LOC. GOV’T CODE ANN. § 214.0015 (West Supp. 1995).

always recover their fees whereas prevailing defendants can recover fees only in exceptional circumstances.”⁸⁸ State judges are as susceptible to mimicking federal practices as their legislative counterparts. In California, “[e]ven when a statute’s language is discretionary and allows for recovery by either party, courts interpret it as presumptively requiring awards to plaintiffs and disallowing fee-shifting to defendants.”⁸⁹ In practice, this judicial doctrine of plaintiff preference precludes victorious defendants from recovering their attorney’s fees unless the plaintiff’s suit is “frivolous, unreasonable, or without foundation.”⁹⁰ Thus, losing defendants are held to a British-style strict liability standard mitigated slightly by the court’s equitable powers, while defeated plaintiffs only reimburse fees under fault-based, negligence principles.

Construing these statutes as shifting fees to prevailing defendants under negligence-based theories is erroneous as a matter of statutory construction. Federal law already imposes a negligence-based regime under which courts may shift fees to parties victimized by wasteful litigation practices: “Any attorney . . . who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorney’s fees reasonably incurred because of such conduct.”⁹¹ Moreover, at least thirty-four states have adopted provisions similar to Rule 11 of the Federal Rules of Civil Procedure that authorize courts to sanction parties engaging in non-meritorious litigation practices by shifting attorneys’ fees.⁹² These statutes are rendered superfluous when judges interpret state fee-shifting laws to transfer attorneys’ fees to defendants under fault-based schemes oriented around buzzwords (“unreasonable,” “frivolous,” “vexatious,” “without foundation”) already operative under existing law.

More significantly, fee-shifting rules skewed toward prevailing plaintiffs induce inefficiency and unfairness into the tort system. Pro-prevailing plaintiff rules undermine the leverage of defendants in settlement negotiations, since the plaintiffs’ bar, cognizant of the expansive bounds prescribed by such terms as “unreasonable” and

88. Joel H. Trotter, *The Catalyst Theory of Civil Rights Fee Shifting After Farrar v. Hobby*, 80 VA. L. REV. 1429, 1432-33 (1994).

89. PEARL, *supra* note 83, at § 2.7; *see* Sokolow v. County of San Mateo, 261 Cal. Rptr. 520, 528 (Ct. App. 1989).

90. *Id.*; *see also* PETER W. LOW & JOHN C. JEFFRIES, JR., CIVIL RIGHTS ACTIONS: SECTION 1983 AND RELATED STATUTES 572 (2d ed. 1994) (observing that under the Civil Rights Attorney’s Fees Awards Act, plaintiffs are only obliged to reimburse the prevailing defendant’s attorney’s fees if the litigation is unreasonable, frivolous, groundless, or vexatious).

91. 28 U.S.C. § 1927 (1988 & Supp. V 1993).

92. Gerald F. Hess, *Rule 11 Practice in Federal and State Court: an Empirical, Comparative Study*, 75 MARQ. L. REV. 313, 315 (1992); *see* FED. R. CIV. P. 11.

“frivolous,” can temper their litigation strategies so as never to do worse than the American Rule regardless of outcome. Defendants, on the other hand, must prevail at trial to avoid subsidizing the as-yet-unknown attorney’s fees of their opponent.⁹³ Without equivalent prospects of fee reimbursement, defendants are under more pressure to settle than their plaintiff-opponents. Consequently, plaintiffs systematically capture a “settlement surplus,”⁹⁴ or premium over and above reasonable compensation for injury that reflects the disproportionate risks to the defendant of litigating.

From an efficiency perspective, the judiciary’s zeal to remove financial obstacles for plaintiffs also imposes social costs on non-parties whose interests are threatened by raising the costs of defendants’ conduct. If widget manufacturers consistently pay higher settlements to injured plaintiffs and/or are obligated to assume disproportionate fee-shifting risk for litigated disputes, they will raise the price of widgets to reflect these increased costs. Perhaps the price of widgets was artificially low under the American Rule due to the over-deterrence of small claims; nonetheless, it is difficult to claim that a rule skewed towards pro-prevailing plaintiffs transmits more accurate signals to producers and consumers than an evenly administered two-way rule that binds each party equally to the merits of their case.

2. Inefficiency resulting from broad statutory discretion granted to the judges who administer hybrid fee-shifting rules

The vast majority of state fee-shifting statutes do not mandate the automatic transfer of attorneys’ fees after the trial is concluded but grant broad discretion to judges to determine when and to what degree the losing party should reimburse the winner for his attorney’s fees.⁹⁵ In the federal system, courts of appeals have developed complex multi-factor balancing tests to assess the propriety of fee shifts under the circumstances of the particular case. The first of these tests emerged from the Tenth Circuit,⁹⁶ which proposed the following five factors for courts to consider: (1) the degree of the offending parties’ culpability or

93. While most fee-shifting statutes limit the victor’s recovery to “reasonable attorney’s fees,” such unknown variables as the nature of discovery, the length of trial, the number of witnesses, and the use of experts can cause significant fluctuations in the amount of attorneys’ fees that a judge would deem “reasonable.” Moreover, defendants are rarely in a position to predict how a judge will perceive the equities of a particular case and allocate fees correspondingly.

94. See Hylton I, *supra* note 7, at 1084-85.

95. See Melissa L. Nelken, *Has the Chancellor Shot Himself in the Foot? Looking for a Middle Ground on Rule 11 Sanctions*, 41 HASTINGS L.J. 383, 402 (1990).

96. *Eaves v. Penn*, 587 F.2d 453, 464-65 (10th Cir. 1978).

bad faith, (2) the ability of the parties to personally satisfy an award of attorney's fees, (3) whether or not an award of attorneys' fees against the offending parties would deter other persons acting under similar circumstances, (4) the amount of benefit conferred on non-parties to the litigation, and (5) the relative merits of the parties' positions.⁹⁷ The Seventh Circuit attempted to simplify the fee-shifting calculus⁹⁸ by establishing a presumption that courts should shift fees to the prevailing party unless (1) the losing party argued a non-frivolous position with a "solid basis," or (2) special circumstances warranted against awarding fees for equitable reasons.⁹⁹

These tests illustrate the amorphous process of administering identically worded state fee-shifting provisions and raise the specter of collateral litigation, or costly legal activity peripheral to the primary dispute that often occurs when fee-shifting rules are applied. Efficiency mavens may accept fee-shifting as an antidote to the necessary evil of litigation, but fee-shifting rules that themselves spawn litigation are unforgivable. Yet rules that fail to shift fees automatically motivate parties to brief and argue the fee-shifting question *ad nauseum* given the high financial stakes.

Another oft-litigated issue implicates the meaning of the phrase "prevailing party" commonly found in state and federal fee-shifting statutes. For example, does a litigant "prevail" if they win but receive only nominal damages?¹⁰⁰ Should plaintiffs be entitled to attorney's fees if the defendant grants the plaintiff a substantial measure of the relief requested through a settlement? Advocates of "catalyst theory" argue that a plaintiff has "prevailed" within the meaning of the relevant statute if the defendant agrees to alter its controversial conduct as a result of the litigation,¹⁰¹ while critics point out that defendants often settle with plaintiffs for reasons having nothing to do with the merits of the plaintiff's complaint.¹⁰² The important lesson for tort reformists is that the collateral litigation spurred by broad delegations of discretion to trial judges and the uncertainty surrounding the "prevailing party" language

97. *Id.* at 465.

98. *Bittner v. Sadoff & Rudoy Indus.*, 728 F.2d 820 (7th Cir. 1984).

99. *Id.* at 830.

100. *See, e.g., Farrar v. Hobby*, 506 U.S. 103, 111 (1992) (ruling that a civil rights plaintiff who sued for \$17 million but only received nominal damages of one dollar was not entitled to attorney's fees: "to qualify as a prevailing party, a civil rights plaintiff must obtain at least some relief on the merits of his claim").

101. Adam Babich, *Fee Shifting after Buckhannon*, 32 ENVTL. L. REP. 10137 (2002).

102. *See Hooper v. Demco, Inc.*, 37 F.3d 287, 292 (7th Cir. 1994) ("A suit may be groundless, and settled for its nuisance value, or settled by a party for wholly gratuitous reasons, thus not justifying an award of attorney's fees.").

results in large inefficiencies.¹⁰³

3. *Inefficiency resulting from the failure of hybrid fee-shifting provisions to encourage compliance with legal rules*

An ideal fee-shifting rule would not only function efficiently after the fact, when a plaintiff alleges injury, but also work backwards to increase incentives for actors to conform their primary behavior to existing legal rules.¹⁰⁴ A fee-shifting rule with automatic application that treats plaintiffs and defendants identically would have the collateral benefit of encouraging compliance with legal rules by making litigation an equally unattractive fall-back position for all potential parties. To illustrate, a fee-shifting statute that imposes disproportionate litigation costs on plaintiffs is inefficient because it emboldens defendants to violate legal rules, secure in the knowledge that financial obstacles will compel their victims to suffer silently out of court.¹⁰⁵ Conversely, the current pro-prevailing plaintiff standard that insures the fees of victorious plaintiffs and limits their exposure in defeat may encourage defendants to over-invest in efforts to adhere to legal rules,¹⁰⁶ while simultaneously encouraging plaintiffs to engage in morally hazardous behavior.¹⁰⁷ Finally, a fee-shifting rule applied unpredictably will likely have randomized effects that impose cumulative inefficiencies; certain individuals or commercial parties may conduct themselves with excessive caution while others engage in careless activity.

Ultimately, fee-shifting rules should function as predictably and equitably as the legal rules under which they operate. Discrepancies in the clarity of fee-shifting rules and legal rules in tort, while frustrating, are understandable in light of their disparate ages and unequal exposure to iterative development. Legal rules inherently defy automatic application, but require common law refinement to guide the exercise of judicial discretion. Hence, one can posit the presence of certain legal

103. See Nelken, *supra* note 95, at 391-92 (“[S]ome judges question whether the frivolous cases Rule 11 keeps out of court might not be less of a burden on the system than the litigation the rule generates over sanctions.”).

104. See Richard L. Abel, *A Critique of Torts*, 37 UCLA L. REV. 785, 808 (1990) (“[J]udges, lawyers, and legal scholars have argued that fear of liability will compel potential tortfeasors to engage in a cost-benefit analysis, taking just those safety precautions that cost less than the accidents they prevent.”).

105. See Michael L. Rustad & Thomas H. Koenig, *Taming the Tort Monster: The American Civil Justice System as a Battleground of Social Theory*, 68 BROOKLYN L. REV. 1, 28-29 (2002) (discussing how legislative immunity leads to dangerous behavior).

106. See Harold J. Krent, *Explaining One-Way Fee Shifting*, 79 VA. L. REV. 2039, 2075 (1993) (§ II, Costs of One-way Fee Shifting).

107. *Id.*

uncertainties while the tort regime endured its growing pains. However, the narrow substantive scope and conceptual simplicity of fee-shifting rules suggest an alternative to the inevitable period of uncertainty under a new fee-shifting regime. State legislators can promulgate fee-shifting rules that are not beholden to an act of judicial discretion, but *presumptively* operate in the absence of extenuating circumstances.

On a normative level, clear legal rules permit people to coordinate their behavior to maximize joint utility. Guido Calabresi observes “as long as individuals are adequately informed about the alternatives and as long as the cost to society of giving them what they want is reflected in the cost to the individual, the individual can decide better than anyone else what he wants.”¹⁰⁸ Until fee-shifting rules attain the same level of refinement as the tort rules that they enforce, civil parties will be unable to coordinate their behavior so as to minimize both their individual transaction costs and the broader social costs resulting from litigation.

VI. REVERSE-COST SHIFTING (RCS)

A. Introduction to RCS

The RCS Rule is conceptually simple: “In civil actions, the losing side pays a multiple of its own costs to the court.”¹⁰⁹ Legislators would fix this multiple, or “compensation factor,” by statute in each jurisdiction.¹¹⁰ If, for example, the multiple is fixed at 1, a plaintiff who expends \$5,000 on a lawsuit and loses would be required to pay an additional \$5,000 to the court. Ephraim Fischbach and William McLauchlan characterize this rule as *reverse-cost shifting* “since the penalty levied against the losing side is determined by the expenditures of the losing side, rather than by the expenses of the winning side as under the [British] Rule.”¹¹¹

The optimality of the RCS rule derives from its automatic application and strong settlement incentives that work in tandem to minimize the transaction costs arising from tort litigation. Procedurally, RCS corrects for the inefficiencies of the pro-prevailing plaintiff regime by (1) automatically levying a penalty on the losing party, and (2) fixing the size of the penalty through a rigid formula that resists judicial variance or modification.¹¹² Moreover, RCS only exposes litigants to a

108. GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 70 (1970).

109. Fischbach & McLauchlan, *supra* note 11, at 39.

110. *Id.*

111. *Id.*

112. *See id.* at 42-44. For legal issues of first impression, or litigation in which the benefits take the form of a public good, the RCS rule might permit judges to waive the fee shift. However,

fee-shift as a function of their own *knowable* legal costs and intentionally divorces the penalty from their opponents' unknowable expenditures. This "reverse-cost" element of the rule, initially introduced in a fee-shifting proposal crafted by the President's Council on Competitiveness ("PCC"),¹¹³ allows plaintiffs and defendants to accurately project their fee-shifting exposure. In the end, this feature not only minimizes transaction costs arising from imperfect information during the litigation process, but also "mitigate[s] the concern that a wealthy litigant could extort submission from an opponent by threatening to conduct a very costly legal campaign."¹¹⁴

Substantively, the RCS rule facilitates litigation efficiency by closely tethering the parties to the merits of their case and increasing the incentives for parties to settle as trial expenses accumulate. Under RCS, a plaintiff who calculates his probability of victory to be below fifty percent *at any point* before or during the trial has strong incentives to either settle or forego a lawsuit entirely. Similarly, a defendant facing a high probability of defeat should offer to settle rather than increase his fee-shifting exposure by continuing to litigate. Thus, unlike the two paradigmatic rules and the pro-prevailing plaintiff scheme, RCS compels parties to constantly reevaluate the status of their case as the litigation continues and RCS exposure increases.¹¹⁵

In close cases, the parties' conception of a "fair" settlement figure will ideally converge as a function of time and, ultimately, intersect at a damages figure that restores the plaintiff as nearly as possible to his pre-injury position.¹¹⁶ Plaintiffs also have substantial disincentives to litigate cases where the probability of success is low and RCS exposure is correspondingly high. The RCS rule can also be tweaked to promote efficient outcomes even when the plaintiff is almost certain to prevail and, therefore, unwilling to engage in settlement discussions. To increase defendants' leverage under these circumstances, the rule may be

note that because the RCS Rule transfers fees to the *court* rather than the opposing party, an actual or anticipated waiver of the fee should not induce inefficient behavior by the opposing party, who does not stand to personally gain or lose by such a decision.

113. See PRESIDENT'S COUNCIL ON COMPETITIVENESS, AGENDA FOR CIVIL JUSTICE REFORM IN AMERICA 24-25 (1991).

114. Bradley L. Smith, Note, *Three Attorney Fee-Shifting Rules and Contingency Fees: Their Impact on Settlement Incentives*, 90 MICH. L. REV. 2154, 2156 (1992).

115. The American Rule and the British Rule do not directly penalize parties as a function of their own litigation expenditures. Therefore, when the case commences parties will make a one-time determination of the probability of overcoming a summary judgment motion (under the American Rule) or prevailing in front of the jury (under the British Rule). A party that decides not to settle before the suit commences has little incentive under these fee-shifting rules to change their mind once the litigation begins.

116. See Elissa M. Meth, Note, *Final Offer Arbitration: A Model for Dispute Resolution in Domestic and International Disputes*, 10 AM. REV. INT'L ARB. 383, 384 (1999).

modified to impose an RCS penalty on the plaintiff (and absolve the defendant of any RCS fee shift) if the jury verdict is less than the defendant's final settlement offer.

The RCS rule also has the potential to single-handedly alleviate one of the more pernicious ills afflicting corporate America—the profligacy of class action lawsuits. Recent amendments to Rule 23 of the Federal Rules of Civil Procedure, along with Congress's enactment in February 2005 of the Class Action Fairness Act,¹¹⁷ were motivated, at least in part, by the complaint of commercial defendants that the certification of a class action lawsuit empowered plaintiffs to extract unduly favorable settlements from defendants unwilling to risk a massive classwide damages verdict at trial.¹¹⁸ Thus, even parties defending against non-meritorious claims are often coerced into settling to avoid the disastrous, if unlikely, scenario that the jury would find for the plaintiff.¹¹⁹

Once a class is certified, it is almost never economically feasible for the defendant to proceed to trial.¹²⁰ Even so, the RCS rule could substantially level the playing field for defendants attempting to settle certified class actions by making the threat to go to trial a meaningful stick in settlement negotiations. Depending on the precise size of the class and the nature of the issues certified for class treatment, the cost of actually litigating a class action lawsuit can be astronomical, inducing a proportionally precipitous rise in the plaintiffs' RCS penalty if they refuse to settle on appropriate terms and then lose at trial.

As these examples illustrate, the elegance of the RCS rule derives not only from its underlying incentive structure, but also from its versatility as a template for tort reform. RCS is an amalgam of components—including *inter alia* the compensation factor, timing of penalty, and the legal significance of settlement offers—that lend themselves to legislative fine-tuning in response to litigation trends and further empirical study. If, for example, policymakers conclude that social efficiency gains from reduced “tort taxes” accrue from all pre-

117. Pub. L. No. 109-2, 119 Stat. 4 (2005).

118. *See ex rel. Prado v. Bush*, 221 F.3d 1266, 1272 (11th Cir. 2000) (“An order granting certification . . . may force a defendant to settle rather than incur the costs of defending a class action and run the risk of potentially ruinous liability.”) (citing Advisory Committee Note, FED. R. CIV. P. 23(f)).

119. *See Waste Management Holdings, Inc. v. Mowbray*, 208 F.3d 288, 293 (1st Cir. 2000) (observing the need for interlocutory appeals of orders certifying a class to provide a “mechanism through which appellate courts, in the interests of fairness, can restore equilibrium when a doubtful class certification ruling would virtually compel a party to abandon a potentially meritorious claim or defense before trial.”). Judge Friendly has referred to settlements induced by a small probability of an immense judgment in a class action “blackmail settlements.” HENRY J. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973).

120. *See Matter of Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1298-99 (7th Cir. 1995).

verdict settlements, they may wish to absolve parties of an RCS penalty no matter when they settle. If legislators target efficiency losses from the litigation process itself as an important goal of reform, they may opt for an RCS rule that imposes a reduced penalty if the parties eschew a pre-trial settlement but ultimately resolve the case before the jury announces its verdict. So long as any variations are established by statute and applied automatically by courts, legislative refinement of the RCS rule will potentially confer substantial advantages over the more rigid American Rule and existing hybrids.

The RCS rule offers important ancillary benefits by shifting the loser's costs to the court rather than the opposing party.¹²¹ Shifting fees to the court as opposed to the winner ensures that the social efficiency gains from these transfers are not eroded by the sub-optimal primary behavior of parties expecting an attorney-fee windfall at trial. The court-shifting requirement also reduces the magnitude of "psychic costs" that motivate parties to increase their own litigation expenses irrationally to avoid conferring a financial benefit on their opponent.¹²² Because litigation often incites animus in the emotionally charged realm of tort, a rule that shifts fees to a neutral party is most likely to encourage efficient behavior. Shifting fees to the court is also attractive insofar as it allocates financial responsibility for operating the civil justice system to the litigants who use it, and not to the taxpayers at large. Hence, it eliminates the taxpayers' "public subsidization" of courts that artificially suppresses the cost to parties of engaging the judicial process.¹²³

Finally, by imposing financial risk on parties who bring suit, the RCS rule indirectly mitigates the ills of contingency fee arrangements,¹²⁴ avoiding any need to confront this popular institution directly.¹²⁵ Under RCS, a lawyer's investment in his client's case is no longer confined to his own time and resources but incorporates the risk of a financial penalty at the close of litigation. Fischbach and McLauchlin observe that "[s]ince an attorney may become responsible for his client's penalty under the RCS rule, one effect of this rule is to bundle the interests of

121. Fischbach & McLauchlan, *supra* note 11, at 41.

122. See Jonathan T. Molot, *How U.S. Procedure Skews Tort Law Incentives*, 73 IND. L.J. 59, 78 (1997).

123. See Stephen J. Choi, *The Problem With Arbitration Agreements*, 36 VAND. J. TRANSNAT'L L. 1233, 1239 n.40 (2003) (noting that "[p]arties who choose to continue through the courts (at least in the [American system]) are subsidized to the extent they do not bear the full cost of operating the judicial system (including the salary of judges, among others)").

124. See, e.g., RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 567-74 (4th ed. 1992) (observing that contingency fee arrangements are criticized for encouraging non-meritorious litigation).

125. See Pfennigstorf, *supra* note 55 (discussing attorney practices in Europe that circumvent legal and ethical prohibitions on contingency fee arrangements).

attorneys and clients together.”¹²⁶ Thus, the same disincentives to litigate imposed on parties are transferred to attorneys working under a contingency fee arrangement. Consequently, attorneys are likely to be more discriminating in the cases they accept on a contingency fee basis and may be particularly reluctant to assume the personal economic risk of litigating a frivolous or nuisance lawsuit on behalf of a non-paying client. To the extent that the plaintiff personally assumes responsibility for paying the RCS penalty, the rule will stimulate price competition among attorneys as clients seek to minimize their RCS exposure by finding attorneys who can limit litigation expenses. Thus, the RCS rule transforms the institution of contingency fee arrangements—historically criticized for encouraging attorney overreaching and litigation excess—into a compelling incentive for lawyers to practice frugally.

The RCS rule is also designed to encourage fair and rapid settlement.¹²⁷ However, scholars do not unanimously agree that the legal system is well served by rules that deter parties from litigating.¹²⁸ Critics of fee-shifting rules that encourage settlement claim that the legal system is robbed of opportunities to develop precedent, a trend that induces stagnation in the law over time. While an in-depth treatment of settlement theory is beyond the scope of this article, two points are worth emphasizing. Concededly, RCS may not be appropriate for blossoming areas of statutory law in which judges play an important role in clarifying ambiguities and adding flesh to skeletal legal standards. However, the marginal value of precedent to a tort system that absorbed the brunt of the litigation explosion is minimal.¹²⁹ Second, the value of precedent is limited to litigation activity preceding the summary judgment phase, at which time the judge determines whether the plaintiff has argued a valid claim as a matter of law. The remainder of the trial, in which the parties dispute which version of the facts the jury should accept, has negligible value as precedent. Therefore, insofar as RCS encourages settlements between the summary judgment stage and the end of the trial, it offers significant advantages over competing alternatives.

B. A Game-Theory Illustration of Litigation Strategy under the American Rule and RCS

As a new fee-shifting paradigm, RCS alters the financial calculus of both parties to a civil proceeding by introducing a penalty that is

126. Fischbach & McLaughlan, *supra* note 11, at 48.

127. *See id.* at 39-40.

128. *See generally* Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984).

129. *See generally* OLSON, *supra* note 2.

inversely proportional to the strength of each party's case. The effect of the RCS penalty on the strategies of the plaintiff and defendant can be modeled using game theory principles. By way of background, game theory is used extensively by economic and political theorists to model decision-making behaviors that involve the choice of a strategy.¹³⁰ The "game" can be represented in graphical format by a simple grid that delineates the possible strategies of each participant and the consequences of each set of strategies, or *strategy profile*.

The Prisoner's Dilemma and a simple variant are useful tools for understanding the application of game theory to fee-shifting rules. The Prisoner's Dilemma hypothesizes that two men ("Alvin" and "Bob") are arrested for a crime they committed together.¹³¹ They are placed in separate rooms and interrogated. The questioners inform each prisoner that if they both plead guilty, they will each serve five years in prison. However, if they both plead innocent, each will spend only one year in jail. If one conspirator confesses and the other maintains his innocence, the confessor will be released as a reward for his cooperation while his partner serves ten years in prison.

The Prisoner's Dilemma can be expressed graphically in a two-by-two matrix, where the first and second numbers in each strategy profile box represent Alvin and Bob's "payoff," respectively:

		Bob	
		Innocent	Guilty
Alvin	Innocent	-1,-1	-10,0
	Guilty	0,-10	-5,-5

Alvin and Bob's decision-making process is analyzed by considering whether, given a particular position in the strategy matrix, a prisoner can improve his position by changing his answer, assuming that his co-conspirator's choice remains the same. Thus, if Alvin assumes that Bob will maintain his innocence, Alvin will spend a year in jail if he also pleads innocent, but will be released outright if he confesses his guilt. On the other hand, if Alvin predicts that Bob will plead guilty, Alvin will spend ten years in prison if he pleads innocent, but just five years if he admits his guilt. Therefore, Alvin benefits by admitting his guilt *regardless* of whether he assumes Bob will confess or maintain his innocence.

130. See generally DREW FUDENBERG & JEAN TIROLE, *GAME THEORY* (1991); MORTON D. DAVIS & LANGDON DAVIS, *GAME THEORY: A NONTECHNICAL INTRODUCTION* (1997).

131. See generally WILLIAM POUNDSTONE, *PRISONER'S DILEMMA* (1992).

Since the payoffs in this scenario are identical for Alvin and Bob, the same reasoning applies to Bob as well. Thus, the strategy profile [Guilty, Guilty] is an equilibrium position. Indeed, this is a *Nash equilibrium*, a position from which no player benefits from changing his strategy, assuming the other prisoner's strategy remain the same.¹³² Since the strategy profile [Guilty, Guilty] is the only Nash equilibrium¹³³ in the Prisoner's Dilemma, the *dominant strategy*¹³⁴ for each player is to confess.

In the early stages of a tort litigation, the plaintiff and defendant choose whether to settle their dispute or proceed with litigation. This decision can be modeled with a strategy matrix similar to the matrix used to represent the Prisoner's Dilemma. Consider a hypothetical products liability lawsuit: *Jones v. Garrity Auto Parts* ("Garrity"). The brakes on Jones's car failed, causing an accident in which Jones sustained minor injuries. We initially examine *Garrity* under the American Rule, employing three assumptions about the costs incurred during this tort proceeding. First, both parties incur a legal fee of \$30,000 for a settlement and \$60,000 for litigation. Second, if Jones is victorious, his judgment will be in the amount of \$300,000. Third, Garrity offers a settlement amount that varies with the strength of Jones's case, but is capped at \$200,000.

We now analyze Jones's decision matrix in three scenarios—where the probabilities of a favorable judgment are 25 percent, 50 percent, and 75 percent. To calculate the payoffs for each strategy profile, we multiply the amount of the judgment or settlement by its probability of occurring and then subtract legal fees.¹³⁵ Note that the payoffs for the strategy profiles [Litigate, Settle] and [Settle, Litigate] are equivalent to [Litigate, Litigate] because the option to settle is feasible only if both parties agree:

132. See FUDENBERG & TIROLE, *supra* note 130, at 11-14.

133. See *id.*

134. A strategy is dominant if it always leads to a higher payoff for one player, regardless of the other player's choice. In the prisoner's dilemma, if Bob claims innocence, Alvin would admit guilt (0) rather than plead innocent (-1). If Bob confesses, Alvin would admit guilt (-5) rather than plead innocent (-10). The same logic works for Bob's decision. Therefore, admitting guilt is the dominant strategy, and claiming innocence is said to be a *dominated* strategy. See *id.* at 6-9.

135. Calculations have been rounded to the nearest ten, and the numbers represent thousands of dollars. See Appendix A for a detailed description of the calculations.

Jones (75%)

		Litigate	Settle
Garrity (25%)	Litigate	-290,170	(-290,170)
	Settle	(-290,170)	-180,120

Jones (50%)

		Litigate	Settle
Garrity (50%)	Litigate	-210,90	(-210,90)
	Settle	(-210,90)	-130,70

Jones (25%)

		Litigate	Settle
Garrity (75%)	Litigate	-140,20	(-140,20)
	Settle	(-140,20)	-80,20

Under the American Rule, Jones stands to receive a larger payoff by litigating than settling until his probability of a favorable judgment falls below 25 percent. Therefore, his dominant strategy will be to litigate all but the weakest cases. However, note that litigation is always an *inefficient*¹³⁶ option for both parties collectively, in that the total cost of litigation (the sum of both payoffs in a strategy profile) is higher than the cost of settlement.

Now consider a variant of the Prisoner's Dilemma, which we term the "Plea Bargain Scenario". In this game, if one conspirator pleads guilty and the other pleads innocent, the party that confesses receives a two-year prison sentence instead of his outright release. This game more closely models prevailing practice in the criminal justice system, where prosecutors use plea bargains to reward co-conspirators with reduced—but not negligible—sentences in return for cooperation. The Plea Bargain Scenario will have different payoffs than the Prisoner's Dilemma for the [Innocent, Guilty] and [Guilty, Innocent] strategy profiles:

		Bob	
		Innocent	Guilty
Alvin	Innocent	-1,-1	-10,-2
	Guilty	-2,-10	-5,-5

136. In this context, we can think of efficiency as a measure of the total cost of settling a dispute, which is the sum of the plaintiff's and defendant's costs. Therefore, the most efficient outcome is the one in which the total cost is minimized.

This new rule has an important consequence. If Alvin thinks Bob will plead innocent, then Alvin is better off following suit, and vice versa. As a result, admitting guilt is no longer the dominant strategy of each player. Instead, Alvin's choice of strategy depends on how likely he thinks Bob is to claim innocence, and vice versa.

Returning to *Jones v. Garrity*, we can now appreciate how the behavior of each party would change under the RCS Rule. Just as the Plea Bargain Scenario modifies the strategy profiles of the Prisoner's Dilemma, RCS introduces an analogous penalty that eliminates the dominance of the litigation strategy under the American Rule. In order to calculate the new payoffs/penalties for each strategy profile, we simply introduce a probability-adjusted fee-shifting penalty incurred by litigating parties. This penalty, which is equal to the party's own legal costs, is incurred by the party that loses a lawsuit. Therefore, Jones and Garrity will each multiply their probability of losing the case by the amount of this penalty and factor the resultant cost into his respective decision:

		Jones (75%)	
		Litigate	Settle
Garrity (25%)	Litigate	-330,150	(-330,150)
	Settle	(-330,150)	-180,120

		Jones (50%)	
		Litigate	Settle
Garrity (50%)	Litigate	-240,60	(-240,60)
	Settle	(-240,60)	-130,70

		Jones (25%)	
		Litigate	Settle
Garrity (75%)	Litigate	-150,-30	(-150,-30)
	Settle	(-150,-30)	-80,20

Under RCS, the payoffs/penalties remain the same for the strategy profile [Settle, Settle]. However, three favorable consequences are evident. First, Jones no longer receives a higher payoff for litigating a case with a 50 percent or lower probability of favorable judgment. In other words, RCS has eliminated the plaintiff's dominant strategy of litigating cases with questionable merit. Indeed, under RCS, Jones actually stands to *lose* money by attempting to litigate a case with less than a 33 percent probability of a favorable outcome. Second, the fee-

shifting penalty makes litigation a less favorable option for *both* parties in all circumstances, demonstrating that RCS even-handedly encourages an efficient settlement. Third, when one party has a 75 percent probability of winning, the range of payoffs/penalties is wider under RCS than the American Rule, which means that the plaintiff enjoys a particular advantage when his case has strong merit and vice versa. This illustrates that in unbalanced civil disputes, RCS tilts the playing field in favor of the party with the stronger case.

A more complex analysis would reveal further benefits of RCS. Since Jones still stands to receive a higher payoff by litigating a case with a 75 percent chance of a favorable outcome, Garrity would probably offer a higher initial settlement, since he would lose an additional \$40,000 (compared to the American Rule) if the case goes to trial. Likewise, if Jones's case is weak, he would be encouraged to accept a lower initial settlement offer to avoid a fee-shifting penalty at trial. Therefore, the settlement reached under RCS would be more efficient than the costly trials so common under the American Rule and more even-handed than the pro-prevailing plaintiff settlements reached under state fee-shifting statutes.

Further game theoretic analyses of tort strategies under the American Rule and RCS could make use of an extensive-form model,¹³⁷ which would introduce a temporal element to the game analyzed above. Such an analysis could demonstrate how the RCS penalty would encourage the parties to engage in iterative rounds of offers and counteroffers, ideally converging on a settlement figure that reflects the actual injury suffered by the plaintiff.

VII. CONCLUSION

Legislators predictably reacted to the litigation explosion by combining elements of the American Rule and the British Rule in an attempt to discourage frivolous litigation and ensure that all plaintiffs with meritorious cases could feasibly access the judicial system. However, the preoccupation of state legislators with ensuring justice on a case-by-case basis led to the establishment of fee-shifting rules that granted excessive discretion to judges and institutionalized a preference for prevailing plaintiffs over prevailing defendants. These rules were initially designed by Congress to enforce newly created federal statutory rights by encouraging plaintiffs to vindicate those rights in court. Not surprisingly, inefficiencies arose as state legislators applied this federal

137. The games analyzed here are represented in *strategic-form*, in which both parties choose their strategies simultaneously, without knowing what the other party has chosen.

model to older and more established state common law rights of action, leading reformers to explore alternate fee-shifting schemes that incorporated a more global view of efficiency while preserving fairness for individual litigants.

The RCS rule evades the pitfalls of prior state efforts by establishing an even-handed two-way fee-shifting system that allocates the costs of legal uncertainty equally to both sides. RCS fundamentally diverges from earlier rules by laboring at the opposite end of the litigation pipeline to preserve fairness through the creation of *disincentives* to non-meritorious parties rather than *incentives* to plaintiffs generally. RCS further protects society by limiting the vulnerability of defendants to non-meritorious lawsuits, thereby minimizing the price distortions to commodities ranging from medical care to sports equipment that result from the flow of settlement surpluses to plaintiffs. By steering parties toward a fair settlement, RCS redefines optimality in the tort system as *efficiency*. In the final analysis, while there may be no talismanic solution to America's litigation explosion, RCS may be a crucial first-step toward recasting the role of litigation in balancing the pursuit of individual redress and the maximization of social welfare.

APPENDIX A

I. VARIABLES

C_s = legal costs for settlement

C_t = legal costs for litigation

P_p = probability of favorable judgment for plaintiff

$P_d = 1 - P_p$ = probability of favorable judgment for defendant

J = judgment for plaintiff

S = defendant's maximum settlement offer

F = RCE fee-shifting fraction

II. AMERICAN RULE

Litigate, Litigate = $(-C_t - P_p J), (-C_t + P_p J)$

Settle, Settle = $(-C_s - P_p S), (-C_s + P_p S)$

III. RCE

Litigate, Litigate = $(-C_t - P_p J - P_p FC_t), (-C_t + P_p J - (1-P_p)FC_t)$

Settle, Settle = $(-C_s - P_p S), (-C_s + P_p S)$