California Western Law Review

Volume 22 | Number 2 Article 4

1986

Closing Pandora's Box: Litigation Economics

Thomas E. Shea

Closing Pandora's Box: Litigation Economics

THOMAS E. SHEA*

INTRODUCTION

> The story of justice, like the story of freedom, is a story that never ends. What seems unrealistic, visionary and unreachable today must be the target even if we cannot reach it soon or even in our time. If we ever begin to think we have achieved our goals, that will mean our sights were set too low or that we had lost concern for our profession or the public interest.[1]

For the society as a whole, and particularly for an individual,[2] to have confidence in the judicial system, there must be a reasonable expectation that not only will the substantive law be fair, but that the procedural aspects of the system will work efficiently to effect the substantive law. If the judicial system does not meet a minimum level of efficiency which society expects from it, there results a lack of confidence.[3] Even though the substantive aspects of the law may be sterling, if the procedural aspects of the law flounder, the judicial system loses respect.

An analysis of economic effects reveals the importance of the efficiency of the judicial system in very real terms. A survey by the National Center for State Courts found that the most serious indictments of the judicial process are that it takes too long and costs too much.[4] A litigant who presses or defends a civil claim should be able to have a justifiable expectation that the substantive law will result in a fair decision regarding the merits of the case. This alone, however, is not necessarily sufficient. Confidence in the effectiveness of the judicial system requires not only that the decisions of the courts be within the general bounds of society's expectations, but also that the process in arriving at those decisions is timely and cost effective.

---

* General Counsel, Commonwealth Companies Incorporated. B.S., Regis College, 1972; M.A., Boise State University, 1974; J.D. University of Denver, 1976.

1. Burger, *The State of Justice*, 70 A.B.A. J., Apr. 1984, at 62, 66.

2. Pound noted: "What is peculiar to Anglo-American legal thinking and above all to American legal thinking, is an ultra-individualism, an uncompromising insistence upon individual interests and individual property as the focal point of jurisprudence." R. POUND, THE SPIRIT OF THE COMMON LAW 37 (1921).

3. "If respect for law is lost because congestion postpones the enforcement of legal rights, a system which operates under a cost structure which helps create the congestion solicits disrespect." Kuenzel, *The Attorney's Fee: Why Not a Cost of Litigation?*, 49 IOWA L. REV. 75, 84 (1963).

4. Memorandum to the Illinois Committee to Study Caseflow—Management in the Law Division, Circuit Court, Cook County, Illinois, January 8, 1982—Introduction.

In its context within the overall society, the judicial system can be thought of as a component which contributes to the well-being of society as a whole.[5] This contribution depends upon the efficiency, effectiveness and fairness of both the procedural and substantive aspects of the judicial system. Black's Law Dictionary speaks of justice, in jurisprudence, as "the constant and perpetual disposition of legal matters or disputes to render every man his due."[6] What is "due" includes not only the decision itself, but also necessarily involves the road to that decision. Society is "due" not only fair substantive laws, but a reasonably efficient, cost effective, and timely method of implementing those laws, and resolving disputes concerning them.

Unfortunately, the judicial system, as it presently operates, does not fulfill its role successfully. The costs and delays incumbent in the legal process have resulted in a loss of confidence.[7] The mechanisms of the legal process have not kept pace with economic developments. Historically, reasons for these mechanisms may be understood in terms of their development, but the same rationales do not pass muster when inspected in the light of present economic conditions. This Article examines the litigation process in terms of its economic effects and suggests changes which would decrease costs and delays and would serve to at least partially close "Pandora's litigation box."

I. THE REALITY OF LITIGATION: INCENTIVES AND DISINCENTIVES

A. A Fair Fight

The independent spirit of American justice must surely find its roots in the spirit of the American Revolution and the sense of importance of the individual.[8] We tend to view the judicial system

5. *See* R. POUND, *supra* note 2, at 139.

6. BLACK'S LAW DICTIONARY 776 (5th ed. 1979).

7. In an interview with Judge Walter Mansfield of the United States Court of Appeals for the Second Circuit, it was noted in the American Bar Association Journal that there is "[a] 'tremendous public demand for action' on court delays, costs and meritless filings [which] is prompting reform." Frank, *On the Merits: Frivolous Suits Targeted*, 70 A.B.A. J., July 1984, at 28. In addition, former Chief Justice Earl Warren stated that "interminable and unjustifiable delays in our courts are today compromising the basic legal rights of countless thousands of Americans and, imperceptibly, corroding the very foundations of constitutional government in the United States." Warren, *The Problem of Delay: A Task for Bench and Bar Alike*, 44 A.B.A. J. 1043 (1958).

8. The Federalist papers demonstrate this revolutionary spirit and demonstrate the concern of several of the founding fathers regarding the importance of the individual as balanced by the needs of an effective government. *See* THE FEDERALIST No. 10 (J. Madison); THE FEDERALIST No. 36 (A. Hamilton); THE FEDERALIST No. 39 (J. Madison); THE FEDERALIST No. 51 (J. Madison); THE FEDERALIST No. 57 (J. Madison).

and litigation as war rather than peace. Litigation is seen, in its highest form, as a "fair fight" to be determined by individual initiative.[9] In the posture of a battle, litigation is used not only as a method or shield to assert or preserve legal rights, but is also used as an economic sword to further purposes which have little or no relation to the merits of the case itself.[10] Right or wrong, an individual is still entitled to fight and is entitled to a day in court.

Because of the sophistication which the legal system has developed in the United States, representation by counsel is a practical necessity in major litigation. Chief Justice Burger recently noted that the 650,000 lawyers in the United States represent two-thirds of all lawyers in the world.[11] The American business establishment has a propensity to litigate rather than to settle disputes by other less formal means, and the concept of litigation has expanded in the United States from being a mechanism of last resort to being an everyday tool in the business arena.[12] Fighting battles through attorney-gladiators has become an established custom.

B. Aggressive Representation

If a fair fight is exalted as a business tool, then aggressive representation by counsel must go with that tool hand-in-hand. Under the American Bar Association Model Rules of Professional Conduct, an attorney has an obligation to diligently represent the client's interests.[13] The paramount duty of counsel is not to resolve a case fairly, but rather to aggressively represent the client within the bounds of ethics.[14] These boundaries give counsel substantial discretion and latitude to assert positions which need only be arguably, rather than probably, correct.

An attorney who plays tough is playing in accordance with the rules. While sanctions against attorneys are available and have been suggested as a cure for abuses,[15] aggressive representation, by itself, is not subject to such sanctions.[16] The problem is not that attorneys

9. R. POUND, *supra* note 2, at 13.

10. *See infra* notes 17-24 and accompanying text.

11. Burger, *supra* note 1, at 62.

12. Litigation is considered by managers as a business activity. They can be expected to engage in litigation only if they expect that it will produce a good return or avert a bad loss. Silverman, *The Consultant's Emerging Role in Managing Complex Cases*, 3 NAT'L L.J., Mar. 30, 1981, at 23, col. 1.

13. MODEL RULES OF PROFESSIONAL CONDUCT Preamble and Rule 1.3 (1983).

14. *See* Hawk v. Superior Court, 42 Cal. App. 3d 108, 116 Cal. Rptr. 713 (1974), *cert. denied*, 421 U.S. 1012 (1975).

15. "In the federal courts the amended rules now authorize sanctions on lawyers for abuse of the privilege. A few carefully considered, well-placed $5,000 or $10,000 penalties will help focus attention on the matter of abuses by lawyers." Burger, *supra* note 1, at 62, 65.

16. *See* Hanley v. Condrey, 467 F.2d 697 (2d Cir. 1972); Troutman v. Southern Ry. Co., 441 F.2d 586 (5th Cir.), *cert. denied*, 404 U.S. 871 (1971).

aggressively assert and protect the positions of their clients, but rather that the system as it is presently constructed does not discourage or adequately consider the economic effects of taking an unrealistic position.

C. *Meritless Litigation*

The result of the fair fight attitude as implemented through aggressive representation by counsel is economically wasteful litigation. Although an action may withstand the test of what constitutes meritless litigation for disciplinary or summary judgment purposes, from a practical standpoint the litigation may still be economically wasteful. This economic inefficiency is now generally borne by the judicial system and meritorious party.

A meritless position may be taken by a party for a variety of reasons. A nuisance suit may be a calculated attempt by a plaintiff to extract a settlement from a defendant who wishes to avoid greater litigation costs.[17] A defendant may wish to delay rightful payment as long as possible. It can even be the case that a party will bring or defend an action based upon subjective good faith, but lack objective merit.

D. *Justice Delayed*

> Delay in the courts is unqualifiedly bad. It is bad because it deprives citizens of a basic public service; it is bad because the lapse of time frequently causes deterioration of evidence and makes it less likely that justice be done when the case is finally tried; it is bad because delay may cause severe hardship to some parties and may in general affect litigants differentially; and it is bad because it brings to the entire court system a loss of public confidence, respect and pride.[18]

In an economic sense, justice delayed is justice denied. The financial pace of our world places a time value on money.[19] Money tomorrow is not equivalent to the same amount of money today. This

---

17. It is demonstrable that it is financially advantageous to go to court. A plaintiff may come with a groundless claim and realize this financial advantage because the defendant will prefer to pay the plaintiff an amount less than the expense of fighting the case. This is the nuisance value of the suit, made possible by making a defendant balance the cost of payment to the plaintiff against the expense of litigating. Defendant's litigation expenses afford the plaintiff a legalized form of blackmail.

Kuenzel, *supra* note 3, at 78.

18. H. ZEISEL, H. HALVEN & B. BUCHHOLZ, DELAY IN THE COURT xxii (1959).

19. "[A]s something can every-where be made by the use of money, something ought every-where to be paid for the use of it." II A. SMITH, WEALTH OF NATIONS (10th ed. N.Y. 1909) (London 1776). The issue of delay is not new. In 1937 Roscoe Pound noted the slow pace of litigation in the American judicial system. Pound, *The Causes of Popular Dissatisfaction With the Administration of Justice*, 20 JUDICATURE 178 (1937).

time value of money plays a substantial motivating and demotivating role regarding the judicial system and the desire of some parties to postpone the litigation process.

There are economic components of the question of delay involving the motivation of a wrongful defendant.[20] A defendant who justly owes a sum of money to a plaintiff has several reasons for using the judicial system to postpone payment of the debt. The primary reason is the value which the money has to the defendant during the process of litigation.[21] Until forced to make payment, the defendant is able to invest the money for the defendant's own purposes. In general, the value of this postponement is related to the rate of return which the defendant can earn on the money. Another motivation of a defendant is that, all else being equal, it may be advantageous for the defendant to postpone paying as long as possible. This postponement can work to the defendant's benefit. Delay can be used as a means for the defendant to obtain a more favorable settlement.[22] If the plaintiff is cash poor, or simply impatient, the plaintiff may be willing to settle for less than the true amount due, rather than face the delay in payment. Additionally, there may be concerns regarding the later solvency of the defendant and the defendant may wish to preserve its fiscal integrity as long as possible.[23] The defendant may even be motivated by a desire to punish the plaintiff.[24]

These factors together work to a great advantage for the wrongful defendant, and to the detriment of the judicial system, by increasing delays.[25] From the purely economic perspective, if the amount due is substantial, the defendant may be better off economically to fight the lawsuit rather than pay what is owed. The counsel fees and other costs associated with defending the litigation may well be less than the interest which the defendant can earn on the money being

20. It is usually the defendant who has motivation in favor of delay. "Thus, the faster the litigation is completed, the better the plaintiff likes it, but not necessarily the defendant." Connolly & Smith, *The Litigant's Perspective on Delay: Waiting for the Dough*, 8 JUST. SYS. J. 271, 277 (1983).

21. The courts are "not unmindful that [high interest rates] create a built-in incentive to withhold sums due, and indeed, to prolong litigation." Peterson v. Crown Fin. Corp., 661 F.2d 287, 298 (3d Cir. 1981).

22. Moore-McCormack Lines v. Richardson, 295 F.2d 583 (2d Cir. 1961), *cert. denied*, 368 U.S. 989 (1962).

23. Boyum & Ferguson, *Resolving Court Delay: The Intersection of Social Science Research and the Judicial Process*, 8 WESTERN ST. U.L. REV. 161, 175 (1981).

24. *Id.*

25. Court backlog is a problem; however, delay is not the only culprit. It is delay when combined with the inflation and high interest rates of today's economy that make court backlog intolerable. Inflation and high interest rates not only compound the economic injustice of delay, they are a significant cause of delay itself.

Londrigan, *Prejudgment Interest: The Case For . . .*, 72 ILL. B.J. 62, 62, 64 (1983).

wrongfully withheld.[26] The defendant may even purposely use the delay through the litigation process to force the plaintiff to settle for less than the full amount due.

Various reasons for delay in the judicial system include discovery abuses,[27] insufficient court administration procedures,[28] and delay tactics by attorneys.[29] From the economic perspective, the precise reason for the delay is not nearly as important as the simple fact that delay occurs. Whatever the cause, delay has an economic cost to the party who is wrongfully denied the amount due and has an economic value to the party withholding payment. This economic value or cost, depending on the perspective of the party, needs to be considered in examining the judicial system from a perspective of economic reality.

From an economic perspective, it is not necessarily required to resolve the relative fault of the parties regarding delay. In fact, it is simpler and less confrontational to speak of the issue in terms of "time" rather than "delay." The time value of money to the parties continues regardless of whether the time for resolution is caused by the system or one of the parties.

E. The Cost of Vindication

It comes as no surprise to anyone reading this Article that attorneys are expensive and the judicial system is a costly mechanism for all involved.[30] Because of the cost of litigation, both in terms of time and money, it may be difficult economically for a party with a just cause to vindicate its position through the judicial system.[31] A party with little financial resources may find itself in a position of not being able to either prosecute or defend a cause of action because of the economic constraints.

The contingency fee system in the United States makes this problem somewhat less acute to a plaintiff than to a defendant. A plaintiff who has a meritorious cause of action can often find an attorney who will be willing to take the case on a contingency fee basis. While this will not relieve the plaintiff from all of the costs associ-

26. At an interest rate of even 10%, the time value of $1,000,000 is $8333.33 per month. If the costs and counsel fees average $5000 per month, the defendant can net $120,000 over three years.

27. Boyum & Ferguson, *supra* note 23, at 175.

28. *Id.*

29. "[L]awyers and not the court are the principal instruments of delay . . . ." Connolly & Smith, *supra* note 20, at 279.

30. Bader & Levine, *Legal Fees: Just How High is Up?*, 3 NAT'L L. J., June 22, 1981, at 1, col. 4.

31. One study showed that "litigation does place a financial burden on most litigants and that the longer a case stays unresolved, the more likely it is that the litigant will be affected." Connolly & Smith, *supra* note 20, at 276.

ated with the action, it does provide a mechanism by which to finance the counsel fees. The option of financing litigation through a contingency fee arrangement is not a practical alternative to a defendant. Since there is no recovery to look forward to at the end of the road, there is no pot of money arising from the case which will be available to pay for the counsel fees under the present system.

Even where a plaintiff or defendant has the resources to finance litigation, from an economic perspective, it may still be advisable to settle even if the amount of settlement does not reflect the true value of the case. This may apply to either the plaintiff or the defendant. Because of the cost of litigation, which is usually unreimbursed under the present system, there is an economic disincentive to litigate. This is probably a positive factor to the extent that it promotes realistic settlements. If a party tends to overvalue its case, the factor for the cost of litigation will tend to moderate the party's position and promote settlement. In general, however, the cost of litigation acts to skew the economic reality of the situation. The decision to settle can be likened to a poker game in which the parties call each other's bluff; each knowing that the other is faced with substantial litigation costs if the case is pursued.

II. Economic Considerations Regarding the Nature of Compensation

A. The Nature of Compensation

The primary purpose of awarding compensation is to place the injured party in the same position in which it would have been if the wrong had not occurred.[32] Although this general statement makes sense, it should not be assumed that the issues regarding compensation have been fully resolved. In terms of macro-historical development of the various common law jurisdictions, there is currently a major debate regarding the basis for the imposition of civil obligations and compensation.[33] Nevertheless, it is difficult to doubt that compensation is the fundamental purpose of awarding damages in civil actions.[34]

32. *See* Tucker v. Calmar S.S. Corp., 356 F. Supp. 709, 711 (D. Md. 1973).

33. Hammond, *Compensation for the Lost Value of Money: A Canadian Proposal*, 99 L.Q. Rev. 68, 73 (1983).

34. Miller v. Robertson, 266 U.S. 243, 257 (1924); Chesapeake & Ohio Ry. v. Elk Ref. Co., 186 F.2d 30 (4th Cir. 1950); Robberson Steel Co. v. Harrell, 177 F.2d 12, 17 (10th Cir. 1949); Davis Cattle Co. v. Great W. Sugar Co., 393 F. Supp. 1165, 1192 (D. Colo. 1975), *aff'd*, 544 F.2d 436 (10th Cir. 1976), *cert. denied*, 429 U.S. 1094 (1977); Superior Tube Co. v. Delaware Aircraft Indus., 60 F. Supp. 573, 574 (D. Del. 1945); City of Danville v. Chesapeake & Ohio Ry., 34 F. Supp. 620, 637 (W.D. Va. 1940); Emery v. Tilo Roofing Co., 89 N.H. 165, 170, 195 A. 409, 412-13 (1937); D. Dobbs, Remedies § 3.1 (1973); 2 F. Harper & F. James, The Law of Torts § 25.1 (1956); C. McCormick, Damages § 5 (1935); W. Prosser, The Law of Torts § 2 (4th ed.

Before the case of *Hadley v. Baxendale*,[35] decided in 1854, the issue of compensation in contract cases was almost completely in doubt. Prior to that case, a jury had virtually unfettered discretion in determining the amount of compensation, since there were practically no rules regarding contract damages.[36] The court in *Hadley v. Baxendale* announced two rules regarding recovery. Under the first, the damaged party may recover compensation (damages) as may fairly and reasonably be considered to arise naturally from the breach of contract. Under the second, the damaged party may recover such damages as may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract, if such damages are the probable result of breach.[37]

The first rule enunciated in *Hadley v. Baxendale* focuses on the concept of damages naturally flowing from a breach of contract, while the second rule concentrates on the contemplation of the parties.[38] Litigation costs and the time value of money are consistent with both the first and second *Hadley v. Baxendale* rules. The breach of a contract naturally results in costs associated with its redress, which may include litigation. If the breaching party does not promptly pay what is owed, these costs naturally fall under the provision of the first rule. Likewise, under the second rule such consequences are the probable result of a breach and may reasonably be supposed to have been in the contemplation of the parties.

With respect to contract damages, compensation can also be viewed from the perspective of the legally protected interests which contracting parties have:

(1) *Restitution Interest*—The interest and benefits conferred upon the other party;

(2) *Reliance Interest*—The detriment incurred by changing of position; and

(3) *Expectation Interest*—The prospect of gain.[39] Breaking down the issue of compensation into these three categories demonstrates

---

1971); Fleming, *The Role of Negligence in Modern Tort Law*, 53 VA. L. REV. 815, 818, 832 (1967); Keeton, *Is There a Place for Negligence in Modern Tort Law*? 53 VA. L. REV. 886, 886-87 (1967).

35. 156 Eng. Rep. 145 (1854).

36. Washington, *Damages in Contract at Common Law* (pts. 1 & 2), 47 L.Q. REV. 345 (1931), 48 L.Q. REV. 90 (1932).

37. Hadley v. Baxendale, 156 Eng. Rep. 145, 151 (1854).

38. A more precise statement of the second rule of Hadley v. Baxendale is "that a party is liable for all the direct damages, which both parties to the contract would have contemplated as flowing from its breach, if, at the time they entered into it, they had bestowed proper attention upon the subject, and had been fully informed of the facts." Leonard v. New York, Albany & Buffalo Electro Magnetic Tel. Co., 41 N.Y. 544, 567 (1870).

39. Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1147-49 (1970).

that the nature of compensation has different aspects, depending upon the circumstances and point of view.

None of these approaches to the issue of compensation is inconsistent with the idea of incorporating the economic effects of litigation in an analysis of compensation due. The three-interest analysis considers compensation from the perspective of the three economic interests of the parties. Under the restitution interest, a party who does not timely pay an amount due has received a benefit by virtue of the time value of money, and this benefit should be compensated. The detriment incurred by a wronged party under the reliance interest should include consideration of all costs, including litigation-associated costs since litigation costs are a detriment. The expectation interest should also include such costs since the prospective gain has been reduced by the litigation costs incurred and the value of money lost.

The first Restatement of Contracts took a somewhat different approach, stating that compensation should include losses caused and gains prevented in excess of savings made possible.[40] Likewise, under the Restatement approach, litigation costs and lost value of money should be compensable. The losses caused to a party include the money spent for litigation. The gains prevented include the return which could have been earned on the amount withheld.

B. Self-Interest and the Law

Some people are good, some people are bad, and some people are in between. It would be desirable for all people to be good and act morally, but approaching the question of the efficiency of the litigation system from a moral perspective does not seem either desirable or necessary. A moral analysis is undesirable because of the quagmire through which one must wallow in order to determine not only who is complying with the moral standards, but also what the moral standards are to be. A moral analysis is unnecessary because the litigation system can be made more effective and efficient by a more behavioral, economic analysis of the issue. It is economically, as well as morally, advantageous that the judicial system be designed in such a manner that it does not rely on the good faith or morality of the participants to ensure its efficiency and success.

As Justice Holmes has noted,

> If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or

40. RESTATEMENT OF CONTRACTS § 329 (1932).

outside of it, in the vaguer sanctions of conscience.[41]

It is therefore advantageous for the legal system to fashion its procedures and methods in such a way that the consequences, and in particular the financial consequences, of a litigant's actions can be self-serving without causing unfairness or uncompensated and undeserved costs to others.

Under a system where the transactional costs of the litigation are incorporated into the overall compensation, concepts such as "delay" and "abuse" would become largely irrelevant. If a litigant is made to pay the actual expenses of the injury caused by abuse of the system, it would be to the party's financial advantage not to abuse the system.[42] In fact, the issue of abuse would largely disappear, since the cost of the abuse is fully compensated. Even a person who cares nothing for an ethical rule of the judicial system is likely, nevertheless, to care to avoid adverse economic effects.[43]

C. Economic Considerations

Economic efficiency should be a goal of the judicial system.

> But even in the most advanced States there are failures and imperfections . . . . [T]here are many obstacles that prevent a community's resources from being distributed . . . in the most effective way. The study of these constitutes our present problem . . . . [I]ts purpose is essentially practical. It seeks to bring into clearer light some of the ways in which it now is, or eventually may become, feasible for governments to control the play of economic forces in such wise as to promote the economic welfare, and, through that, the total welfare, of their citizens as a whole.[44]

The substantial nature of the costs associated with the litigation process requires that these costs be taken into consideration in judging the efficiency and effectiveness of the judicial system. Accordingly, compensation must include consideration of the time value of money and the transaction costs involved. The economic considerations which are presently at play in the litigation arena promote delay and increase transaction cost. It would be preferable for the legal system to recognize the economic consequences of its methods and the impact which these economic influences have upon litigants.[45]

---

41. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897).
42. Kuenzel, *supra* note 3, at 80.
43. Holmes, *supra* note 41, at 459. "If it is true that a certain part of society is taking advantage of court delay to put financial pressure on an adversary, a solution which requires payment for the advantage would appear appropriate, particularly if the congestion problem itself is being caused by a similar motivation." Kuenzel, *supra* note 3, at 78.
44. A. PIGOU, THE ECONOMICS OF WELFARE, 129-30 (4th ed. 1932).
45. The true cause of delay is economic, and our judicial system has no better control over the economy than does the legislature. However, our legal sys-

There are two essential components to the economics of litigation. The first component involves transaction costs, or in other words, costs and counsel fees; the second component involves the time value of money. Each of these components must be evaluated in terms of its effect on the litigation system.

III. TRANSACTION COSTS: COUNSEL FEES AND OTHER EXPENSES

The transaction costs of counsel fees and other expenses incurred throughout the litigation process make these costs a significant consideration in analyzing the economics of the system. The traditional approach in the area substantially differs from that taken by England and a majority of civil law countries.

A. The English Rule

The practice of awarding a victorious litigant some approximation of legal costs began as early as the Roman Empire.[46] This tradition has expanded whereby in modern times the English routinely include an assessment for reasonable counsel fees and costs to be borne by the losing party.[47] The historical development of this attitude in England was a gradual process.

> What some modern practitioners may think the most interesting topic of the law was as yet much neglected [prior to the time of Edward I] . . . . It is highly probable that in some actions in which damages were claimed a successful plaintiff might often under the name of damages obtain a compensation which would cover the costs of litigation as well as all other harm that he had sustained; but we know that this was not so where damages were awarded in the action for land, and in many actions for land no damages, and therefore no costs, could be had. It is only under the statute that a victorious defendant can claim costs, and at the time of which we write statutes which allowed him this boon were novelties. *In expensarum causa victus victori condemnandus est*—this is a principle to which English, like Roman, law

---

> tem must recognize the economic realities of today and their impact upon litigants. In a period of continuing inflation, commercial interests have been quick to recognize that it is good business to pay off today's debts with tomorrow's inflated dollars.
>
> . . . .
>
> . . . [C]ourt backlog has become a legal limbo where claims linger until settled; often these settlements are on the eve of trial. Under this system, the defendant who retains the money is economically rewarded and the plaintiff economically penalized.

Londrigan, *supra* note 25, at 64 (footnote omitted).

46. Note, *Distribution of Legal Expense Among Litigants*, 49 YALE L.J. 699, 705 (1940).

47. *See* R. JACKSON, THE MACHINERY OF JUSTICE IN ENGLAND 518 (7th ed. 1977).

came but slowly.[48]

The Statute of Gloucester[49] was enacted in the year 1278, providing for costs of the plaintiff's writ to be included as an increment of the judgment. The statute was broadly construed, however, and Lord Coke noted that:

> Here is express mention made but of the costs of his Writ, but *it extendeth to all* the legall cost of the suit, but not to the costs and expences of his travell and losse of time, and therefore costages commeth of the verb conser, and that againe of the verb constare, for these costages must constare to the court to be legall costs and expences.[50]

The same privilege was later extended to the prevailing defendant.[51]

In looking to the motivation of the English regarding compensation for legal costs, Arthur Goodhart noted: "The purpose of the courts [in England] is to administer justice and not to referee a game between two players."[52] The result of the English rule is "that in England a litigant rarely brings or defends an action without realizing that costs are a major consideration . . . ."[53] The English rule has had a beneficial effect on limiting court congestion, holding down costs and discouraging non-meritorious suits, thus contributing to the efficiency and quality of British justice.[54] In this, the British are not alone. A majority of civil law countries provide for some form of award of legal costs to the prevailing party.[55]

B. The American Rule

Early English colonial courts in America routinely awarded attorney fees to the successful litigant, but following the American

---

48. F. POLLOCK & F. MAITLAND, II THE HISTORY OF ENGLISH LAW 597 (2d ed. 1952) (footnotes omitted).

49. Statute of Gloucester, 1278, 6 Edw., ch. 1.

50. E. COKE, INSTITUTES OF THE LAWES OF ENGLAND (2d pt.) 288 (N.Y. 1979) (1st ed. London 1642).

51. 23 Hen. 8, ch. 15, § 1; 4 Jac., ch. 3, § 1.

52. Goodhart, *Costs*, 38 YALE L.J. 849, 865 (1929).

53. *Id.* at 850.

54. Greenberger, *The Cost of Justice: An American Problem, An English Solution*, 9 VILL. L. REV. 400, 400-01 (1964).

55. Baeck, *Imposition of Fees of Attorney of Prevailing Party Upon the Losing Party Under the Laws of Austria*, 1962 A.B.A. SEC. INT'L COMP. L. PROC. 119; Baeck, *Imposition of Legal Fees and Disbursements of Prevailing Party Upon the Losing Party—Under the Laws of Switzerland*, 1962 A.B.A. SEC. INT'L COMP. L. PROC. 124; Dietz, *Payment of Court Costs by the Losing Party Under the Laws of Hungary*, 1962 A.B.A. SEC. INT'L COMP. L. PROC. 131; Freed, *Payment of Court Costs by the Losing Party in France*, 1962 A.B.A. SEC. INT'L COMP. L. PROC. 126; Rubin & Staford, *The Sources of South African Law of Costs*, 65 S. AFR. L. J. 387 (1948); Schima, *The Treatment of Costs and Fees of Procedure in the Austrian Law*, 1962 A.B.A. SEC. INT'L COMP. L. PROC. 121; Shartel & Wolff, *Civil Justice in Germany*, 42 MICH. L. REV. 863 (1944).

Revolution, the courts adopted the American rule of no recovery.[56] Under the common law American rule each party must pay its own litigation costs and counsel fees.[57] If there was any doubt during the early days of the country as to whether America would follow the English rule, such doubt was put to rest by the Supreme Court in 1796, which firmly enunciated that the English rule would not prevail.[58]

The American rule has been explained in terms of the sporting theory of justice.[59] The fact that Americans may approach litigation with a more sporting spirit than their English counterparts may at least partially explain the adoption of the American rule. Another reason may lie in a general revolutionary attitude of early America toward the English system, including a rejection of at least some of the legal principles from across the sea. The revolution created a resentment of English law[60] which may have caused the early American judicial system to frown on the English system regarding costs. In the early days of our country, a citizen could represent himself in court and an attorney was considered a luxury[61] and, in fact, assistance of counsel was often looked upon as not essential.[62] In colonial America, attorneys were not well loved.

> In every one of the Colonies, practically throughout the Seventeenth Century, a lawyer or attorney was a character of disrepute and of suspicion, of whose standing or power in the community the ruling class, whether it was the clergy as in New England, or the merchants as in New York, Maryland and Virginia, or the Quakers as in Pennsylvania, was extremely jealous. In many of the Colonies, persons acting as attorneys were forbidden to receive any fee; in some, all paid attorneys were barred from the courts; in all, they were subjected to the most rigid restrictions as to fees and procedure.[63]

The judicial system of the United States still has an aversion to awarding attorney fees[64] and the United States, therefore, remains in the small minority by taking the position that the losing party is not responsible for paying for the prevailing party's

56. Stoebuck, *Counsel Fees Included in Costs: A Logical Development*, 38 U. COLO. L. REV. 202, 207 (1966).

57. Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975); Natural Resources Defense Council, Inc. v. EPA, 703 F.2d 700, 704 (3d Cir. 1983).

58. Arcambel v. Wiseman, 3 U.S. (3 Dall.) 306 (1796).

59. Goodhart, *supra* note 52, at 876-77.

60. R. POUND, *supra* note 2, at 112-17.

61. Mayer & Stix, *The Prevailing Party Should Recover Counsel Fees*, 8 AKRON L. REV. 426, 427 (1975).

62. Goodhart, *supra* note 52, at 873.

63. C. WARREN, A HISTORY OF THE AMERICAN BAR 4 (1911) (footnote omitted).

64. Wheeler & Lavan, *The Equal Access to Justice Act: The "American Rule" Revisited*, 15 PUB. CONT. L.J. 60, 61 (1984).

representation.[65]

Under the common law American rule, there is no right to recover attorney fees.[66] This rule not only applies to state courts, but also to the federal courts, which generally do not have the power to award attorney fees to a prevailing party without express statutory authorization.[67] The American rule applies in equity actions as well as in actions at law.[68]

Even though the American common law general rule is that counsel fees and litigation costs are not recoverable as damages, statutes may provide for such recovery.[69] The imposition of costs[70] and attorney fees[71] has been upheld as constitutional. As a result, there presently exists a haphazard patchwork of statutes which provide for reimbursement of litigation expenses in one form or another.[72]

In addition to the statutory exceptions to the American rule, there are two minor exceptions at common law which have sometimes been invoked. The first exception occurs when the losing

65. Rowe, *The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651.

66. Arcambel v. Wiseman 3 U.S. (3 Dall.) 306 (1796); Stone-Easter, Inc. v. City of Seattle, 121 Wash. 520, 209 P. 687 (1922); Perlus v. Silver, 71 Wash. 338, 128 P. 661 (1912).

67. Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975). Hall v. Cole, 412 U.S. 1 (1973); Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714 (1967).

68. Tevander v. Rysdael, 299 F. 746 (7th Cir. 1924).

69. *See* E. LARSON, FEDERAL COURT AWARDS OF ATTORNEY'S FEES 323-27 (1981). Compensation for attorney fees is available under: antitrust laws, 15 U.S.C. § 15 (1982); the Communications Act, 47 U.S.C. § 206 (1982); the Copyright Act, 17 U.S.C. § 505 (1982); the Fair Labor Standards Act, 29 U.S.C. § 216(b) (1982); the Merchant Marines Act, 46 U.S.C. § 1227 (1982); the Interstate Commerce Act, 49 U.S.C. § 11705(d)(3) (1982); the Packers and Stockyard Act, 7 U.S.C. § 499g(b) (1982); the Railway Labor Act, 45 U.S.C. § 153(p) (1982); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78i(e), 78u(h)(7)(A) (1982); and laws concerning import items, 15 U.S.C. § 72 (1982).

70. City of Miami v. Murphy 137 So. 2d 825 (Fla. 1962); Marquardt v. Fisher, 135 Or. 256, 295 P. 499 (1931); Daniel v. Daniel, 116 Wash. 82, 198 P. 728 (1921).

71. Life & Cas. Ins. Co. v. McCray, 291 U.S. 566 (1934); Vogel v. Pekoc, 157 Ill. 339, 42 N.E. 386 (1895); Union Cent. Life Ins. Co. v. Chowning, 86 Tex. 654, 26 S.W. 982 (1894).

72. Research for the author by students at the University of Nebraska Law School reveals a variety of statutory provisions dealing with recovery of counsel fees. Because of space limitations, only the number of such provisions by state is listed. A compilation of statutes is on file at the California Western Law Review offices. Alabama—4; Alaska—48; Arizona—15; Arkansas—26; California—158; Colorado—2; Connecticut—72; Delaware—126; Georgia—21; Hawaii—50; Idaho—19; Illinois—66; Indiana—10; Iowa—42; Kansas—54; Kentucky—8; Louisiana—74; Maryland—7; Maine—37; Massachusetts—36; Michigan—20; Minnesota—19; Missouri—10; Mississippi—33; Montana—82; Nebraska—62; Nevada—1; New Hampshire—4; New Jersey—38; New Mexico—4; New York—31; North Carolina—4; North Dakota—51; Ohio—7; Oklahoma—66; Oregon—118; Pennsylvania—47; Rhode Island—1; South Carolina—36; South Dakota—20; Tennessee—7; Texas—60; Utah—23; Vermont—23; Virginia—20; Washington—81; West Virginia—3; Wisconsin—58; Wyoming—1.

party has acted in bad faith.[73] Under the bad faith exception, a party who litigates in bad faith can be held responsible to pay the attorney fees of the other party.[74] The bad faith exception is punitive[75] rather than compensatory in nature. It has been allowed where the defendant engaged in extensive evasive and dilatory tactics[76] and may be based upon the conduct of litigation,[77] whereby the recovery is limited to the costs caused by bad faith.[78] At least one court has stated that it is not the motive behind the conduct of litigation but rather the methodology which serves as the test for bad faith.[79] The bad faith exception may also include the filing of unmeritorious litigation, which requires subjective bad faith and a finding that the claim is unsupported by probable cause.[80]

The other exception to the American rule occurs when a common fund or benefit results from the litigation. Under this exception, a court may award attorney fees to a litigant if the efforts have resulted in a common fund to be shared by a class.[81] The purpose of the common benefit exception is to serve as an incentive to induce forceful prosecution of such cases which benefit a class of persons.[82]

C. *Costs of Litigation*

Costs are allowances to a party to an action for the party's expenses incurred in a legal proceeding.[83] As with counsel fees, courts do not have inherent power to award costs.[84] Although there are

73. *See* Spencer v. NLRB, 712 F.2d 539, 543 (D.C. Cir. 1983), *cert. denied*, 466 U.S. 936 (1984).

74. Roadway Express, Inc. v Piper, 447 U.S. 752 (1980).

75. Hall v. Cole, 412 U.S. 1, 5 (1973).

76. First Nat'l Bank v. Dunham, 471 F.2d 712, 713 (8th Cir. 1973).

77. Tenants & Owners in Opposition to Redev. v. United States Dep't of Hous. & Urban Dev., 406 F. Supp. 960, 964 (N.D. Cal. 1975).

78. Nemeroff v. Abelson, 620 F.2d 339, 351 (2d Cir. 1980); Browning Debenture Holders' Comm. v. DASA Corp., 560 F.2d 1078, 1089 (2d Cir. 1977); Wright v. Jackson, 522 F.2d 955, 958 (4th Cir. 1975).

79. Lipsig v. National Student Mktg. Corp., 663 F.2d 178, 182 (D.C. Cir. 1980).

80. Nemeroff v. Abelson, 620 F.2d 339, 348 (2d Cir. 1980); Browning Debenture Holders' Comm. v. DASA Corp., 560 F.2d 1078, 1088 (2d Cir. 1977). *See* Lipsig v. National Student Mktg. Corp., 663 F.2d 178, 182 (D.C. Cir. 1980).

81. *See generally* Dawson, *Lawyers and Involuntary Clients in Public Interest Litigation*, 88 HARV. L. REV. 849, 850-51 (1975); Dawson, *Lawyers and Involuntary Clients: Attorney Fees From Funds*, 87 Harv. L. Rev. 1597 *passim* (1974); Note, *Award of Attorneys' Fees From Entire Common Fund in Class Action Judgments Does Not Violate No-Fee American Rule*, 11 CUM. L. REV. 501, 505-16 (1980); *See also* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 257-59 (1975); Hall v. Cole, 412 U.S. 1 (1973); Mills v. Electric Auto-Lite Co. 396 U.S. 375 (1970).

82. "Quite obviously, a major incentive to forceful prosecution is the substantial counsel fee plaintiffs' attorney believes he may be awarded if he is successful." Dolgow v. Anderson, 43 F.R.D. 472, 495 (E.D.N.Y. 1968).

83. Hoffman v. Morgan, 206 Okla. 567, 245 P.2d 67 (1952); Bennett v. Kroth, 37 Kan. 235, 15 P. 221 (1887).

84. Redfield v. Davis, 42 S.D. 556, 176 N.W. 512 (1920); Pierce County v.

substantial parallels between the American rule regarding counsel fees and the American rule regarding costs, the two issues are not identical. For example, the terms "costs" or "expenses" as used in a statute do not ordinarily include attorney fees.[85]

In principle, the economic issues regarding costs and counsel fees are the same. The treatment of costs and counsel fees by the courts has also been similar. At common law, costs were not recoverable,[86] but the right to recover costs could exist by statutory authority.[87] Since there was no common law right to the payment of costs, statutes relating to costs are strictly construed.[88]

D. An Analysis of Transaction Costs and Litigation

The diametrically opposed viewpoints of the American and English rules stand in stark contrast to each other. The philosophies which underlie the rules are very different. From an economic perspective, however, it is not the underlying philosophies, but rather the results, which are of paramount consideration. At the heart of an analysis of this issue lies the concept of transaction costs.

> Of course, if market transactions were costless, all that matters (questions of equity apart) is that the rights of the various parties should be well-defined and the results of legal actions easy to forecast. But as we have seen, the situation is quite different when market transactions are so costly as to make it difficult to change the arrangement of rights established by the law. In such cases, the courts directly influence economic activity. It would therefore seem desirable that the courts should understand the economic consequences of their decisions and should, insofar as this is possible without creating too much uncertainty about the legal position itself, take these consequences into account when making their decisions. Even when it is possible to change the legal delimitation of rights through market transactions, it is obviously desirable to reduce the need for such transactions and thus reduce the employment of resources in carrying them out.[89]

The transaction costs of litigation include both counsel fees and

---

Magnuson, 70 Wash. 639, 127 P. 302 (1912); *Ex parte* Cudd, 195 Ala. 80, 70 So. 721 (1916).

85. Turner v. Zip Motors, Inc., 245 Iowa 1091, 65 N.W.2d 427 (1954). Vonachen v. Independent Lumber Co., 172 Kan. 545, 241 P.2d 775 (1952).

86. Goudy v. Mayberry, 272 Ill. 54, 111 N.E. 526 (1916); State Highway Comm'r v. Goodman, 349 Mich. 311, 84 N.W.2d 507 (1957); *In re* Improvement of Third St., St. Paul, 179 Minn. 258, 228 N.W. 925 (1930); Houghton v. Barton, 49 Utah 611, 165 P. 471 (1917).

87. Antoni v. Greenhow, 107 U.S. 769 (1882); Bissing v. Turkington, 113 Conn. 737, 157 A. 226 (1931); *In re* Improvement of Third St., St. Paul, 179 Minn. 258, 228 N.W. 925 (1930); *In re* Donges's Estate, 103 Wis. 497, 79 N.W. 786 (1899).

88. City of Ottumwa v. Taylor, 251 Iowa 618, 102 N.W.2d 376 (1960); Townsend v. Boatmen's Nat'l Bank, 159 S.W.2d 626 (Mo. 1942); Curti v. Franceschi, 60 Nev. 422, 112 P.2d 819 (1941).

89. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 19 (1960).

other expenses. As noted earlier, during the early days of our country one could represent one's self and the transaction costs would be insubstantial. Under today's complex judicial system, however, this is no longer a realistic possibility. Litigation is often expensive and complex. The rationales which fostered the adoption of the American rule are no longer applicable.

Essentially, there are two rationales for shifting transaction costs: equity and incentive.[90] Underlying the equity side of the argument is the realization that counsel fees and litigation costs are a true component of the damages suffered by the prevailing party. A plaintiff who is forced to seek redress through the judicial system suffers the transaction costs involved. If the plaintiff's position proves correct, these transaction costs should be part of the compensation received since they constitute damage which the plaintiff has suffered. On the other hand, if a defendant is wrongfully accused and prevails in an action, the defendant has suffered damages by virtue of the transaction costs involved and should equally be reimbursed from the wrongful plaintiff. The transfer of cost burden of counsel fees to the unsuccessful litigant compensates the innocent party.[91]

The second rationale for cost shifting lies with the incentive which would be created. "The possibility of having to pay the lawyer's bills of both parties to the action makes a plaintiff think twice before he sues out a writ and a defendant think twice before he defends an action which ought not to be defended, and that is a direct deterrent on the number of cases put or kept in suit."[92] Adoption of the English rule would serve as a powerful incentive to reduce court congestion and deter non-meritorious litigation.[93]

It has been argued that the English rule is unwarrantedly based on the assumption that the losing party in litigation is always or

---

90. Rowe, *supra* note 65, at 651-52.
91. Mayer & Stix, *supra* note 61, at 427.
92. 1 MASS. JUD. COUNCIL REP. 63 (1925).
93. The court calendar would not be as populous with the disappearance of strike actions and groundless claims of would-be plaintiffs who now bring actions with no chance of winning. This legal blackmail which forces the defendant to settle for an amount that is not justly owing the plaintiff would be unable to achieve its economic goal. A defendant would not be able to force a prevailing plaintiff into time-wasting litigation by groundless appeals.

In other words, with attorney fees awarded to the prevailing party, legal blackmail and the necessity to balance the cost of settlement against the expense of litigation will cease to be a potent tool to prevent justice.

Mayer & Stix, *supra* note 61, at 429-30.

It is not only as a means of discouraging unfair and unnecessary litigation that costs have proved so efficacious in England. They may be of even greater use in controlling each step of the case from summons to final appeal—in preventing prolixity, delay, misjoinder of parties, the demand for the production of undisputed evidence, and the taking of appeals as a matter of course.

Goodhart, *supra* note 52, at 862.

even ordinarily in the wrong. Under this argument, it is urged that in spite of conscientious and painstaking efforts, even an enlightened judge, in a given case, is as likely as not to do injustice when seeking to do justice.[94] This argument presupposes a fundamental lack of faith in the judicial process. Under the theory of this argument, it would be advised for *no* award of damages to be made in *any* case, since the decision of the court might be incorrect.

It has also been urged that there would be a possible chilling effect on meritorious litigation if the English rule is used,[95] and that the inability to predict precisely the outcome of the case makes it inequitable to assess attorney fees.[96] This argument against the English rule also fails. There is no doubt that adoption of the English rule would have a chilling effect on litigation. It should not, however, have a chilling effect on *meritorious* litigation. Rather, it would encourage meritorious pursuit of rightful claims. Under the present system, a plaintiff with a relatively small claim is often discouraged or practically prevented from asserting that claim through the litigation process where the expected costs would exceed the expected recovery.

> On the other hand, the fact that allowance of counsel fees might deter a few skeptical defendants who fear that court or jury might fail to recognize their just defenses, would seem less objectionable than the present system under which many more, though confident that the law would properly decide in their favor, now refuse to defend suits in which they would ultimately, though relieved of paying an unjust claim, have to spend counsel fees far exceeding that claim.[97]

94.

> The scheme urged[, that the loser is to pay all costs,] is based on the wholly unwarranted assumption that the losing party in litigation is always, or even ordinarily, in the wrong. Its sole justification must be that an adverse verdict by a jury or an unfavorable decision of the Court carries with it the necessary conclusion that the defeated party was morally culpable in bringing action, or in resisting suit, as the case may be. Nothing could be further from the actual facts of life.
>
> . . .
>
> An enlightened Judge must realize that, in spite of his most conscientious and painstaking efforts, he is, in a given case, as like as not to do injustice when he seeks to do justice.

Satterthwaite, *Increasing Costs to be Paid by Losing Party*, 46 NEW JERSEY L.J. 133, 133 (1923).

95. Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714, 718 (1967); Sands, *Attorneys' Fees as Recoverable Costs*, 63 A.B.A. J. 510, 513 (1977).

96. Kall & Shpall, *Attorneys' Fees Awarded to the Prevailing Party: The Ghost of S.B. 258 Revisited*, 11 COLO. LAW. 3003, 3004-05 (1982).

97. Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CALIF. L. REV. 792, 797 (1966).

IV. COMPENSATION FOR THE TIME VALUE OF MONEY

The time value of money constitutes the second major economic component influencing the litigation process. Along with the transaction costs involved, the parties to litigation are substantially influenced by considerations regarding the time value of money as it relates to the time taken by the judicial process to reach a conclusion.

A. A Historical Perspective

> Whatever may have been our archaic notions about interest, in modern financial communities a dollar to-day is worth more than a dollar next year, and to ignore the interval as immaterial is to contradict well-settled beliefs about value. The present use of my money is itself a thing of value, and, if I get no compensation for its loss, my remedy does not altogether right my wrong.[98]

As noted in this quotation written by Judge Learned Hand, the historical ideas regarding interest do not correspond with modern economic reality. Responsibility for the reluctance of the judicial system to include the time value of money as an intregal part of full compensation is based on historical perspective. Aristotle wrote of the charging of interest as being wrong.[99] This negative attitude toward interest was not easily changed, and its effects were felt in early common law. Under early common law, interest was viewed as illegal and usurious.[100] Finally, in 1545, the Act against Usury was adopted decriminalizing the charging of interest.[101]

This ancient and long enduring attitude against interest has its roots in morality rather than economics.

> Historically, attitudes toward interest tended to focus on moral issues to the exclusion of more mundane economics. Since in

98. Procter & Gamble Distrib. Co. v. Sherman, 2 F.2d 165, 166 (S.D.N.Y. 1924).

99. ARISTOTLE, 1 POLITICS 10 (B. Jowett trans. lst ed. 1943); ARISTOTLE, 4 NICHOMACHEON ETHICS 1, in INTRODUCTION TO ARISTOTLE, at 374-79 (R. McKeon ed. 1947).

100. Lowe v. Waller, 99 Eng. Rep. 470, 472-73 (1781); Van Rensselaer v. Jewett, 2 N.Y. 135, 140 (1849); Adriance v. Brooks, 13 Tex. 279, 281 (1855); Laycock v. Parker, 103 Wis. 161, 79 N.W. 327 (1899); 8 W. HOLDSWORTH, HISTORY OF ENGLISH LAW 100-13 (2d ed. reprint 1966); 1 J. SUTHERLAND, THE LAW OF DAMAGES §§ 301-03 (J. Berryman 4th ed. 1916).

101. An Act against Usury, 1545, 37 Hen. 8, ch.9. The preamble states:

> Where before this Time divers and sundry Acts Statutes and Laws have been ordained had and made within this Realm, for the avoiding and Punishment of Usury, being a Thing unlawful, . . . which Acts . . . been so obscure and dark . . . and upon the same so many Doubts Ambiguities and Questions have risen and grown, and the same Acts . . . been of so little Force or Effect, that by reason thereof little or no Punishment hath ensued to the Offenders of the same, but rather hath encouraged them to use the same.

Id.

> early societies the needy rather than the merchants borrowed money, the moral duty of charity overshadowed the investment potential for money, and interest was generally considered immoral. Originally the word usury referred to the taking of any interest on loans, as opposed to its modern meaning, the charging of an exorbitant rate.[102]

It is important to understand, however, that the conditions which precipitated such an aversion to the payment of interest in earlier days do not necessarily apply to our more complex system today. In fact, the legal system gradually grew to recognize that, not only should the charging of interest not be illegal, but also that an express contract to pay interest should be enforceable.[103] This was followed by a recognition that at least in certain limited circumstances interest could be considered as damages in the absence of an express agreement.[104] Over the years, courts and commentators have been moving away from medieval notions that all interest is evil, and toward a recognition of the time value of money.[105]

Gradually, some courts started to understand that interest is a legitimate and fair component of damage awards.[106] The common law tradition, however, stands in the way of full recognition and

---

102. Kein & Kein, *Opportunity Cost: A Measure of Prejudgment Interest*, 39 BUS. LAW. 129, 129 (1983).

103. [The enforceability of express contracts to pay interest] was followed by a recognition of the fact that a refusal to pay money legally due, like a refusal to perform any other legal duty to another, merited condemnation and punishment from the courts, and the doctrine of interest as *damages*, in absence of express agreement, became established; but it was allowed as damages and by way of punishment to a wrongdoer.

Laycock v. Parker, 103 Wis. 161, 179, 79 N.W. 327, 332 (1899) (emphasis in original).

104. *Id.*

105. Courts in other jurisdictions and commentators have over the years been moving away from medieval religious notions that all interest was evil toward recognition by awarding prejudgment interest of the economic fact that money awarded for any reason is worth less the later it is received . . . .

At the moment the cause of action accrued, the injured party was entitled to be left whole and become immediately entitled to be made whole . . . . All damages then, whether liquidated or unliquidated, pecuniary or nonpecuniary, should carry interest from the time the cause of action accrues . . . .

The following hypothetical case illustrates the injustice of denying prejudgment interest. Suppose A inflicts precisely the same amount of damage of any type on B and C at the same moment, evaluated by juries as $1,000 each. If C wins his judgment a year later than B and does not get prejudgment interest for the year, C recovers less than B for the same injury; C has been deprived of the use value of $1,000 for one year while B has enjoyed the use value . . . . Only by awarding prejudgment interest from the time the cause of action accrues, when a plaintiff is entitled to be made whole, can the sort of injustice which happened to C in the hypothetical case be avoided. We are also influenced by the policy consideration that failure to award prejudgment interest creates a substantial financial incentive for defendants to litigate even where liability is so clear and the jury award so predictable that they should settle.

State v. Phillips, 470 P.2d 266, 273 (Alaska 1970) (footnotes omitted).

106. Miller v. Robertson, 266 U.S. 243, 258 (1924) (dictum); Newburgh Land & Dock Co. v. Texas Co., 227 F.2d 732, 734 (2d Cir. 1955) ("interest is awarded on the

implementation of compensation for the time value of money as a basic component of judgments. As a result, there presently exists an incomplete patchwork of statutes which provides for the payment of interest under a variety of circumstances.[107] There does not presently exist in America, however, a comprehensive method of fully compensating litigants for the time value of money.

B. Effecting Full Compensation for the Time Value of Money

The adoption of a system of compensation for the time value of money requires a fundamental perception that interest is compensatory rather than punitive.[108] In awarding compensation for the time value of money, a court need not cast moral dispersions nor involve itself in a process of punishment. Rather, the subject can be approached on a more objective, economic basis.

Full and adequate compensation needs to include a recognition of this time factor.

> An award two years after an injury occurs is certainly not the equivalent of an award made at the time of injury; and the great weight of authority is to the effect that full compensation . . . requires that, even in the case of unliquidated demands, account be taken of the period that has elapsed between the damage and the award and that allowance be made for interest.[109]

Essentially, the award of interest is to compensate the claimant for the loss of money the claimant would have earned if payment had not been unduly withheld.[110] Thus, the loss of the use of money is equated to the cost value of money.[111]

The award of compensation for the time value of money would have two positive effects. First, it would be consistent with the na-

---

theory that it is indemnity for the delay in paying for the loss"); Dana v. Fiedler, 12 N.Y. 40, 50-51 (1854).

107. Research for the author by students at the University of Nebraska Law School reveals a variety of statutory provisions dealing with recovery of interest. Because of space limitations, only the number of such provisions by State is listed. A compilation of these statutes is on file at the California Western Law Review offices. Alabama—2; Alaska—2; Arizona—2; Arkansas—3; California—6; Connecticut—7; Delaware—2; Florida—5; Georgia—2; Hawaii-2; Idaho—3; Illinois—2; Indiana—4; Iowa—2; Kansas—11; Kentucky—1; Louisiana—2; Maine—1; Maryland—3; Massachusetts—7; Michigan—3; Minnesota—2; Mississippi—14; Missouri—8; Montana—2; Nebraska—8; Nevada—1; New Hampshire—1; New Mexico—1; New York—6; North Dakota—4; Ohio—3; Oklahoma—5; Oregon—7; Pennsylvania—3; Rhode Island—2; South Carolina—2; South Dakota—4; Tennessee—4; Texas—9; Utah—5; Vermont—4; Virginia—7; Washington—2; West Virginia—3; Wisconsin—4; Wyoming—5.

108. Busik v. Levine, 63 N.J. 351, 358, 307 A.2d 571, 575, *appeal dismissed*, 414 U.S. 1106 (1973).

109. Chesapeake & Ohio Ry. v. Elk Refining Co., 186 F.2d 30, 33 (4th Cir. 1950).

110. Busik v. Levine, 63 N.J. 351, 358, 307 A.2d 571, 575, *appeal dismissed*, 414 U.S. 1106 (1973).

111. *See* Hammond, *Compensation for the Lost Value of Money: A Canadian Proposal*, 99 L.Q. REV. 68 (1983).

ture of fair compensation. Second, this would remove a significant economic incentive to delay settlements.[112]

CONCLUSION

Confidence in the judicial system requires the system to function efficiently by minimizing costs and time from an economic perspective. It is advantageous to approach the efficiency issue from a practical, behavioral standpoint rather than by using a moralistic approach. By using an economic analysis, the efficiency of the judicial system can be improved without uncertain reliance on the differing moral perspectives of parties and counsel.

The economic approach is consistent with the general principle of compensation which places the wronged party in the same economic position as it would have been had the wrong not occurred. Under the present system, transaction costs and the time value of money are not compensated, thus resulting in decision making by parties and their counsel based upon economic advantages and disadvantages which have little relation to the merits of the case. This failure of the judicial system to adequately compensate for transaction and time value of money costs creates disadvantages both to meritorious parties and to the judicial system as a whole.

The roots of our traditional rejection of these considerations lie in the revolutionary and independent spirit of America. Along with the increased sophistication of our society has come the utilization of litigation as a weapon sometimes wielded to take advantage of an economic blindspot in the law. Our traditional rejection of including transaction and time value of money costs as legitimate components of compensation has been eroding. As a result, there exists a haphazard and logically inconsistent patchwork of exceptions.

The crumbling confidence of society in the judicial system requires that this economic imbalance be addressed. By providing economically just compensation for transaction costs and time value of money costs, the economic motivations for delay and meritless litigation will be substantially reduced, resulting in a more efficient and fair judicial system.

---

112. When a court determines the amount of money owed the plaintiff, the defendant or the insurance company should pay interest on this money that it has been using profitably during that period. This is called prejudgment interest. Its purpose is to make the plaintiff whole by accounting for the use of the money during the pendency of the lawsuit.

Prejudgment interest is a concept of fairness and equity, not a sanction against the defendant. . . . Prejudgment interest is assessed only if the case is not settled and a court is required to determine liability and the amount of damages owed. Its incidental effect is to remove the economic incentive to delay settlements.

Londrigan, *supra* note 25, at 64.