# FEE! FIE! FOE! FUM!: I SMELL THE EFFICIENCY OF THE ENGLISH RULE[1] FINDING THE RIGHT APPROACH TO TORT REFORM

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[1] This title is a parody from the rhyme "Fee! Fie! Foe! Fum!" featured in the children's fairytale *Jack and the Beanstalk.* The original lyrics are as follows: "Fee! Fie! Foe! Fum! I smell the blood of an Englishman. Be he live, or be he dead, I'll grind his bones to make my bread." JOSEPH JACOBS, "*Jack and the Beanstalk*", ENGLISH FAIRY TALES (1890).

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## *I. Introduction*

The American tort imbroglio has now moved the United States into a new era with a new practice: treat everyone like imbeciles! The culture of shifting personal responsibility to a third party, notwithstanding common sense and even culpability, is the pervasive message of the day from willing plaintiffs' lawyers. One need not go further than the local department store to see how entangled the

American tort weave has become.

> A fishing lure label warns: "HARMFUL IF SWALLOWED."[2]
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> A snow sled label warns: "BEWARE: SLED MAY DEVELOP HIGH SPEED UNDER CERTAIN SNOW CONDITIONS."[3]
>
> A smoke detector warns: "WILL NOT EXTINGUISH A FIRE."[4]
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> A Harry Potter toy broom label reads: "THIS BROOM DOES NOT ACTUALLY FLY."[5]
>
> A Rowentra iron label reads: "DO NOT IRON CLOTHES ON THE BODY."[6]
>
> A Bayer aspirin bottle reads: "DO NOT TAKE IF ALLERGIC TO ASPIRIN."[7]
>
> A fold-up stroller reads: "REMOVE CHILD BEFORE FOLDING."[8]

American products are simply riddled with nonsensical warning labels that are the result of a risk-free, litigious society, the hallmark of the American tort scheme. Today's product labels are a testament to the fact that there is truth in labeling. The American tort scheme is broken and is nothing short of an "international embarrassment and a domestic scandal,"[9] as it not only feasibly allows for but also promotes the filing of baseless suits. Consequently, not a single class of adults is safe from the harm of such a potential suit, thereby

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[2] Michigan Lawsuit Abuse Watch, Past Winners of M-LAW's Wacky Warning Label Contests, http://www.mlaw.org/wwl/pastwinners.html (last visited Oct. 15, 2006).

[3] Common Good: Wacky Warning Labels, http://cgood.org/society-45.html (last visited Oct. 15, 2006).

[4] Michigan Lawsuit Abuse Watch, Past Winners of M-LAW's Wacky Warning Label Contests, http://www.mlaw.org/wwl/pastwinners.html (last visited Oct. 15, 2006).

[5] The Dumb Network, Dumb Warnings, http://www.dumbwarnings.com/warnings.php?site=warnings&cid=11 (last visited Oct. 15, 2006).

[6] George Will, *Validation By Defeat,* NEWSWEEK, Nov. 22, 2004, at 86.

[7] The Dumb Network, Dumb Warnings, http://www.dumbwarnings.com/warnings.php?site=warnings&cid=8 (last visited Oct. 15, 2006).

[8] Michigan Lawsuit Abuse Watch, Past Winners of M-LAW's Wacky Warning Label Contests, http://www.mlaw.org/wwl/pastwinners.html (October 15, 2006).

[9] Todd J. Zywicki, *Public Choice and Tort Reform* 2 (Geo. Mason Law & Economics Research Paper No. 00-36, 2000), *available at* http://papers.ssrn.com/paper.taf?abstract_id=244658.

inciting unwarranted legal fear[10] in the heart of Americans and triggering a need for nonsensical warning labels.

A *Newsweek* cover story, "Lawsuit Hell," captures the essence of the problem in the ordinary modern-day tort-damage claim in the United States.[11] The exposé found that:

> Americans will sue each other at the slightest provocation. . . . But Americans don't just sue big corporations or bad people. They sue doctors over misfortunes that no doctor could prevent. They sue their school officials for disciplining their children for cheating. They sue their local governments when they . . . get hit by drunken drivers, get struck by lightning on city golf courses-and even when they get attacked by a goose in a park (that one brought the injured plaintiff $10,000). They sue their ministers for failing to prevent suicides. They sue their Little League coaches for not putting their children on the all-star team. They sue their wardens when they get hurt playing basketball in prison. They sue when their injuries are severe but self-inflicted, when their hurts are trivial and when they have not suffered at all. Many of these cases do not belong in court. But clients and lawyers sue anyway, because they hope they will get lucky and win a jackpot from a system that allows sympathetic juries to award plaintiffs not just real damages—say, the cost of doctor's fees or wages lost—but millions more for impossible-to-measure 'pain and suffering' and highly arbitrary 'punitive damages.' (Under standard 'contingency fee' arrangements, plaintiffs' lawyers get a third to a half of the take.).[12]

What is the cost of the American tort scheme? The citizenry pays the cost in the form of higher prices and a loss of products or services that it desires.[13] A recent oft-cited study estimates that every American pays an annual $809 tort tax, amounting to more than 2% of the gross domestic product in the United States.[14] These costs are

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[10] Such legal fear should be characterized as "unwarranted" because the current scheme allows for the filing of suit subjecting individuals to lawsuits even though such individuals acted with the optimal amount of care.

[11] Stuart Taylor Jr. & Evan Thomas, *Civil Wars*, NEWSWEEK, Dec. 15, 2003, at 45.

[12] *Id.*

[13] *See* Seth Stern, *Lawsuits, Lagging Economy Linked in Tort Reform Push*, CONG. Q. WKLY., 1270, 1273 (2004); *see also infra* Part IX.C.

[14] TILLINGHAST-TOWERS PERRIN, U.S. TORT COSTS: 2003 UPDATE, at 1 (2003). The consulting firm Tillinghast-Towers Perrin conducted the study in February 2003. According to Tillinghast, the cost of lawsuits, which includes the payments to plaintiffs, attorney fees, and overhead, increased 13.3% in 2002 to $233 billion, larger than the state of Tennessee's economy and much larger than the overall

equivalent to a 5% tax on wages and are approximately two-and-a-half times higher than the average of most foreign industrialized nations.[15] The American Medical Association claims that because of the increase in insurance premiums due to the mounting legal costs patients are losing access to medical care in eighteen states.[16] The American tort scheme can also be linked to job loss. Due to the rising costs to produce a good or service caused by legal fear, prices go up and individuals buy less, which leads to the need for fewer employees. Legal fear also seems to be responsible for the rise in outsourcing of jobs outside of the United States. In a March 2004 Senate floor speech, Senator Christopher Bond of Missouri claimed that brick manufacturers were moving to Canada to avoid the risks of asbestos lawsuits.[17] The cost of the American tort scheme, although seemingly subtle, is unmistakably damaging to the way society is conducted in the United States.

The recent emphasis on tort reform has led to the introduction of numerous bills in the United States Congress and in many states throughout the nation.[18] Tort reform efforts are, in large part, well intended. They are designed to hold individuals responsible for their own actions and reinvigorate the economy. The problem with some tort reform efforts is that they do not meet these goals and do more damage than good. The most common type of tort reform effort, capping the amount that a plaintiff can collect, is no different. There is no question that something must be done to fix the broken American tort scheme. The question that should be asked is how to best accomplish such a feat from an efficiency standpoint? Shakespeare's solution to first "kill all the lawyers" is certainly not an option.[19] What seems to be missing from the forefront of the United

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economic growth of 3.6%. *Id.* at 1-2; *see* Stern, *supra* note 13, at 1272-73 ("Tillinghast studied Denmark, Japan, Australia, Canada, France, United Kingdom, Switzerland, Spain, Germany, Italy and Belgium. After the United States, the country in the survey with the highest percentage of GNP flowing to tort costs was Belgium, with 1.4%; the lowest two were Australia and Japan, at 0.4% and 0.5% respectively.").

[15] Tillinghast-Towers Perrin, *supra* note 14, at 1; *see also* Zywicki, *supra* note 9, at 2.

[16] *See* Stern, *supra* note 13, at 1270, 1273.

[17] *Id.*

[18] *See* Henry Cohen, *Good Samaritan Tort Reform: Three House Bills*, CRS REP. FOR CONG., Sept. 15, 2004; Henry Cohen, *Federal Tort Reform Legislation: Constitutionality and Summaries of Selected Statutes*, CRS REP. FOR CONG., Jan. 27, 2006; Henry Cohen, *Medical Malpractice Liability Reform: Legal Issues and Fifty-State Survey of Caps on Punitive Damages and Noneconomic Damages*, CRS REP. FOR CONG., Jan. 18, 2006. For a sampling of state-introduced bills see the National Association of Mutual Insurance Companies' website at http://www.namic.org/scorecard/03TortReform.asp.

[19] WILLIAM SHAKESPEARE, THE SECOND PART OF KING HENRY THE SIXTH act 4, sc. 2. 1.76-7 ("The first thing we do, let's kill all the lawyers.").

States tort reform debate is a vigorous discussion of the economic effects of moving towards a fee-shifting tort scheme and the efficiency pitfalls of capping damage awards.[20]

As Adam Smith wrote in *Wealth of Nations*, "Lawyers and attorneys, at least, must always be paid by the parties . . . ."[21] In the climate of the call and need for tort reform, the utmost important and vital question from an economic standpoint is, "Which party should pay the legal fees?" Another question is, "How much should attorneys be paid?" In other words, should attorneys' fees as well as the amount of money the plaintiff can win be capped or limited in any way? As demonstrated below, the answers to these questions have an enormous impact on litigation and can result in the imposition of large economic costs or benefits to society.

There are two general approaches to attorneys' fees in the ordinary tort damage claim, commonly known as the "American Rule" and the "English Rule."[22] The American Rule, practiced in the

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[20] One-way fee shifting schemes are fairly common in the United States. *See infra* note 31. However, the concept of moving from the current American scheme to a two-way fee shifting scheme has not been without its prominent supporters. In 1991, Vice-President Dan Quayle's Council of Competitiveness proposed fee shifting. *See e.g.*, PRESIDENT'S COUNCIL ON COMPETITIVENESS, AGENDA FOR CIVIL JUSTICE REFORM IN AMERICA (1991); Susanne Di Pietro & Teresa W. Carns, *Alaska's English Rule: Attorney's Fee Shifting in Civil Cases*, 13 ALASKA L. REV. 33, 38 (1996). On the heels of the proposal, President George H.W. Bush issued an Executive Order providing for fee shifting in the limited circumstances of which the United States initiated civil suits in Federal Court. Exec. Order No. 12,778, 3 C.F.R. 359 (1992), *reprinted in* 28 U.S.C. § 519 (1994). In 1994, the Republicans led by Newt Gingrich in the Contract with America introduced the Common Sense Legal Reform Act, which provided for two-way fee shifting in certain types of Federal litigation. *See* Note, *'Common Sense' Legislation: The Birth of Neoclassical Tort Reform*, 109 HARV. L. REV. 1765, 1769 (1996). In the 108th Congress, Senator Lindsey Graham and Congressman Chris Chocola introduced companion bills in their respective chambers titled, The Legal Expense Equity Act of 2004. S. 1836, 108th Cong. (2003); H.R. 4430. 108th Cong. (2004). These bills would have established a set of guidelines under which either party of a civil lawsuit in federal court could be required to pay the opposing side's attorney fees. *Id.* In his Dear Colleague to other Members urging that they cosponsor his bill, Congressman Chocola stated: "Frivolous lawsuits brought by irresponsible trial lawyers are hurting our nation—driving up healthcare costs, putting doctors out of business, eliminating thousands of jobs, while devastating our economy . . . . It is time to reform the tort process by ensuring that both defendants and plaintiffs have a vested interest in each case brought before a judge." Press Release, Congressman Chris Chocola, *It's time to hold people who file frivolous lawsuits accountable for their actions*, (May 19, 2004) (on file with author). Congressman Chocola introduced the same bill with a different title in the 109th Congress. *See* Frivolous Lawsuit Reduction Act of 2005, H.R. 2393, 109th Cong. (2005).

[21] ADAM SMITH, THE HARVARD CLASSICS VOL. X: WEALTH OF NATIONS 313 (C.J. Bullock ed., P.F. Collier & Son 1909–14) (1776).

[22] Herbert M. Kritzer, *Lawyer Fees and Lawyer Behavior in Litigation: "What Does the Empirical Literature Really Say?"*, 80 TEX. L. REV. 1943, 1946 (2002). Fee shifting rules

United States, provides that each side is responsible for its own lawyers' fees regardless of the outcome.[23] The English Rule, the predominate practice in civil law countries and the United Kingdom, provides that the losing party is responsible for the winning party's legal fees.[24] Under the American Rule, in a contingent fee arrangement, which is the predominate pay scheme in United States tort cases, the plaintiff typically risks no monetary expense and his reluctance to sue is greatly diminished.[25] The obvious result of such a plaintiff-favored fee scheme is that the ostensibly injured plaintiff is more inclined to file a tort claim, notwithstanding the plaintiff's chance of winning.[26] The typical mindset under the American rule is

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require that the losing party in litigation pay some or all of the winning party's legal expenses, including attorneys' fees. *See id.* There are four basic options of paying for legal services: (1) the user of legal services pays the fee with his own money; (2) the opposing party pays the fee; (3) a third party pays the fee; or, (4) the lawyer performs the service for no fee (pro bono). *Id.* The main purpose of a fee shifting scheme is to make the winning parties whole. *Id.* This article will not examine the fairness of making the winning party whole or the general purpose of a fee shifting scheme. For a discussion of the fairness aspect, see President's Council on Competitiveness, *supra* note 20, at 24 (The English rule "is grounded in fairness—in the equitable principle that a party who suffers should be made whole."). For a discussion of the general purposes of a fee shifting scheme, see Thomas D. Rowe, Jr., *The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651 (1982) (This article examines several reasons for a fee shifting scheme: it is only just to have the loser pay the winner's legal costs, to make a litigant financially whole for a legal wrong suffered, and to deter and punish misconduct, among others.). Common sense tells us, however, that which party will be required to pay the legal fees will have an overall effect on the approach parties will take in handling a dispute. After all, the largest item of expense in tort litigation is the attorneys' fees. *See* RICHARD EPSTEIN, CASES AND MATERIALS ON TORTS 902-03, (6th ed., Little Brown and Company 1995).

[23] Kritzer, *supra* note 22, at 1946-47; *see also* EPSTEIN, *supra* note 22, at 902, 903 ("[T]he American practice on this point stands virtually alone among the advanced industrialized nations.").

[24] *See* Kritzer, *supra* note 22, at 1946; EPSTEIN, *supra* note 22, at 903.

[25] EPSTEIN, *supra* note 22, at 897, 904. Epstein describes the contingent fee system as follows:

> [T]he plaintiff's attorney agrees to receive compensation for services rendered only out of the funds that the plaintiff receives from the defendant, either by settlement or judgment. In the event that the action is lost, therefore, the plaintiff's attorney receives nothing for time and effort expended. This system is not in general use in any other legal system; indeed, in England, for example, it is specifically prohibited as an "unethical practice."

*Id.*; *see also* Werner Pfennigstorf, *The European Experience with Attorney Fee Shifting*, 47 LAW & CONTEMP. PROBS., 37, 59 (1984).

[26] As discussed *infra*, a rational plaintiff will choose to litigate when the return from litigation is greater than the expected cost of litigation. Under the American rule, in a contingency fee case, the plaintiff will almost always choose to litigate since there is no expected cost of litigation if the plaintiff loses. *See* EPSTEIN, *supra* note 22, at 903. Such willingness to litigate was even captured in *Mr. Nanny*, a recently

best described by the apothegm uttered by most American tort plaintiff lawyers: "You can always sue!"[27] In fact, most Americans see it as their "right" to sue anyone who annoys them, regardless of fault, forcing the other person to bear the burden of defending a lawsuit.[28]

Through the lens of economic theory, this article will establish the purpose of an efficient tort scheme, theoretically analyze the socially optimal level of behavior and damages, and examine how the most popular tort reform effort, limiting liability or imposing caps on damages[29], will impact the socially optimal level of behavior. Using three types of efficiency criteria, this article will argue in favor of the English Rule for the ordinary tort damage claim and against limiting liability, first by analyzing a change in the current American tort scheme to one of limited liability and then by analyzing a change from the current scheme to the English Rule.

This article will further discuss the differences in the two general approaches to fee-shifting rules in common-law and civil-law countries, with a brief examination of the history of both the English and American Rules. Using a normative analysis, the article will then theoretically analyze the economic impact of a fee-shifting tort scheme, the English Rule, and the economic impact of not having such a scheme in place, the American Rule, with an emphasis on contingency fee arrangements.[30]

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released American film. *See* MR. NANNY (New Line Cinema 1993). In that film, a "tough-guy" character was questionably injured by the protagonist. *Id.* The protagonist asked the tough-guy if he was going to start a fight. *Id.* The tough-guy responded, "No, don't be silly, I am going to sue you." *Id.* (The preceding dialogue is the author's own rendition and recollection of the scene and does not reflect an actual verbatim transcript from the film.)

[27] *See* Jean R. Stearnlight, *Is Binding Arbitration a Form of ADR?: An Argument That the Term 'ADR' Has Begun to Outlive its Usefulness*, 2000 J. DISP. RESOL. 97, 108 n.57 (2000) ("As the old saying goes, 'you can always sue,' even if the suit won't get too far."); Barry Fox, *You Might Hurt Yourself, But You Can Always Sue*, THE HARRISBURG PATRIOT (PA), July 12, 2002, at I03.

[28] *See, e.g.*, Taylor & Thomas, *supra* note 11, at 45; Lorraine Wright Feuerstein, *Two-Way Fee Shifting on Summary Judgment or Dismissal: An Equitable Deterrent to Unmeritorious Lawsuits*, 23 PEPP. L. REV. 125, 127 (1995) ("[T]he cynical view is that it is every American's right to legally harass anyone he chooses.").

[29] For purposes of this article, references to "limiting liability" and "damages caps" bear the same meaning.

[30] As will be demonstrated *infra*, the consideration of contingency fee arrangements is essential when attempting to conduct an economic analysis on the two general approaches to fee shifting, an area which has been unfortunately omitted in other published works on fee shifting. *See* Avery Wiener Katz, *Indemnity of Legal Fees*, 7300 ENCYCLOPEDIA OF LAW AND ECONOMICS 63, 89 (1999), *available at* http://encyclo.findlaw.com/tablebib.html (An "analysis of the effects of fee shifting under contingent fee contracts, accordingly, remains to be undertaken.").

In particular, the article will examine the impact of fee-shifting on the filing of frivolous and weak lawsuits, decisions to settle rather than going to trial, the overall volume of litigation, and the development of the law. The article will also demonstrate the diminishing acceptance of personal responsibility under the American Rule and how the English Rule will promote a shift to personal responsibility. The theoretical conclusion reached by the article is that under a rational decision making fee-shifting scheme the tort legal process will run more efficiently and that such a scheme is the most efficient approach to tort reform in the United States. A tort system under a fee-shifting scheme would be sufficiently efficient that limiting liability or imposing caps on damages would not only be unnecessary, but also would do more economic harm than good. The article also explores the idea of statutory valuation for noneconomic damages as an adjunct to a fee-shifting scheme. Although the author believes that the theories advanced in this article, if adopted, would lead to the most efficient outcome, it is admittedly quite difficult at times to achieve the most efficient outcome through the political process.

## *II. What is the Purpose of an Efficient Tort System?*

Before any effort is invested in tort reform, the purpose of an efficient tort system must first be established. The traditional view seems to be that fairly compensating victims or making them whole is the purpose of tort liability; in other words, the purpose is to place the victim in the position that he would have enjoyed if the tort had not been committed.[31] This traditional view, however, seems to be giving way to the deterrence school of thought.[32] With the ubiquity and affordability of insurance, compensating victims for their losses no longer seems as important as creating incentives for potential

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[31] Sullivan v. Old Colony St. Ry. Co., 83 N.E. 1091, 1092 (Mass. 1908). In *Sullivan*, Chief Justice Rugg wrote:

> The rule of damages is a practical instrumentality for the administration of justice. The principle on which it is founded is compensation. Its object is to afford the equivalent in money for the actual loss caused by the wrong of another. Recurrence to this fundamental conception tests the soundness of claims for the inclusion of new elements of damage.

*Id.*

[32] *See* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 268 (2004).

tortfeasors[33] to behave optimally. However, fully compensating victims, as discussed below, is wholly intertwined with deterring risky behavior and is a mandatory element in achieving the optimal level of behavior. Society is better off when potential tortfeasors behave optimally and reduce the risk of accidents or, better yet, prevent them from happening. Such optimal behavior can only be reached when potential tortfeasors have incentive to behave at the optimal level. Thus, the chief purpose of an efficient tort system should be to reduce the risk of accidents through proper incentives.[34]

## *III. Socially Optimal Level of Behavior*

Now that the purpose of an effective and efficient tort system has been established, it is now necessary to determine the socially optimal level of behavior that an optimally functioning tort system will want to incentivize. Once this is established, then one can examine what type of tort reform efforts are needed to meet the purpose of an efficient tort system, which is accomplished through proper incentives, and discover the behavior that the law should aim to incentivize.[35]

### A. *Level of Care*

A level of care is the amount of precautions that a potential tortfeasor takes prior to or during an activity in question. The socially optimal level of care minimizes total social costs.[36] Total social costs are the sum of the expected accident losses and the cost

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[33] A tortfeasor in this article means an individual or entity that is negligent. An individual or entity is negligent if the marginal cost of a precaution is less than the cost of harm and the probability of harm, otherwise known as the "Learned Hand Rule." United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947).

[34] John C. Moorhouse, Andrew P. Morris & Robert Whaples, *Law & Economics and Tort Law: A Survey of Scholarly Opinion*, 62 ALB. L. REV. 667, 667 (1998) ("[I]n the works of mainstream scholars, deterrence has now assumed the role of a primary rationale for tort liability rules."); SHAVELL, *supra* note 32, at 268-69 ("[I]f the liability system has a real purpose today, it must lie in the creation of incentives to reduce risk. . . . [R]educing accident risks . . . if anything, should be the warrant for use of the liability system.").

[35] Unless otherwise noted, this article will focus only on the law of negligence and will assume that all parties are risk-neutral. A risk-neutral party will make decisions based on expected values. SHAVELL, *supra* note 32, at 178. In addition, unless otherwise noted, the article will also assume accidents are unilateral in nature. That is, only a potential tortfeasor's actions affect accidents risks; a victim's behavior does not affect such risks.

[36] *See* SHAVELL, *supra* note 32, at 178.

of the care that a potential tortfeasor has to take.[37] What then is the level of care that minimizes total social costs?

Assume that there are three standards of care: (1) no care; (2) moderate care; and (3) high level of care. If there is an accident, suppose that it will cause $1000 in losses. The cost of care is as follows: (1) $0 for no care; (2) $100 for moderate care; and (3) $200 for high level of care.[38] The probability of an accident under each level of care is as follows: (1) 30% for no care; (2) 15% for moderate care; and (3) 7% for high level of care. Based on the above figures, the expected accident losses for each level of care are as follows: (1) $300 for no care;[39] (2) $150 for moderate care;[40] and (3) $70 for high level of care.[41] Taking the sum of expected accident losses and the cost of care, we can now determine the total social costs for each level of care. The total social costs for each level of care are as follows: (1) $300 for no care;[42] (2) $250 for moderate care;[43] and (3) $270 for a high level of care.[44] This simple example demonstrates that moderate care is the socially optimal level of care because it is the level of care that minimizes total social costs.[45] This is true even though expected accident losses are lower with the use of a high level of care.

Now that it has been demonstrated that moderate care is the socially optimal level of care, the next step is to determine how much care a potential tortfeasor is likely to employ under a no liability rule, a negligence rule, or a strict liability rule. This will serve as a basis to illustrate how a tort system can be most efficient, that is, structured to incentivize a potential tortfeasor to exercise the socially optimal level of behavior—moderate care. Under a no liability rule, a potential tortfeasor is not incentivized to take any care at all, let alone the socially optimal level of moderate care.[46] A potential tortfeasor would simply not see an incentive to incur a cost to improve his level of behavior since he gains no benefit from improving his behavior.[47]

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[37] *See id.*

[38] This is a reasonable assumption since a potential tortfeasor has to incur a cost for each precaution that he takes ex ante.

[39] *30% x $1000 = $300.*

[40] *15% x $1000 = $150.*

[41] *7% x $1000 = $70.*

[42] *$0 (cost) + $300 (expected accident losses) = $300.*

[43] *$100 (cost) + $150 (expected accident losses) = $250.*

[44] *$200 (cost) + $70 (expected accident losses) = $270.*

[45] *See* SHAVELL, *supra* note 32, at 178-79.

[46] *See id.* at 179.

[47] *See id.*

The potential tortfeasor will not be liable regardless of the level of care he employs.

A negligence rule scheme holds a potential tortfeasor liable for the accident losses that he causes when he acts in a negligent manner.[48] Courts define negligence as acting below a level of due care.[49] If courts set due care at the socially optimal, moderate level of care, which will be assumed here, then a potential tortfeasor will be incentivized to act at the socially optimal level.[50] This can be demonstrated using the same costs of care as above at each level of care. For example, if a potential tortfeasor takes no care, his expected liability is $300.[51] Thus, his total costs are $300.[52] If a potential tortfeasor takes moderate care, his expected liability is $0 because he acts with due care and is therefore not liable. His total costs are $100,[53] which is the cost of taking a moderate level of care. A potential tortfeasor that takes a high level of care will incur $0 of expected liability because he acts above the level of due care. His total costs are $200 for taking an extra amount of precaution.[54]

The potential tortfeasor is undoubtedly in a better position by employing the socially optimal, moderate level of care. A potential tortfeasor will not employ the higher level of care because he can avoid liability by taking moderate care and without having to incur additional costs, in this case an additional $100. Moreover, choosing below the moderate level of care exposes a potential tortfeasor to potential liability; in this case, the expected liability is $300. Therefore, under the general negligence rule, a potential tortfeasor would want to take the socially optimal, moderate level of care, which provides the least amount of cost to the potential tortfeasor.[55] Likewise, under a strict liability rule, where tortfeasors must pay for all losses that they cause, potential tortfeasors will be induced to take the socially optimal, moderate level of care, since that level incurs the least amount of social costs.[56]

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[48] *See* Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29-34, 36-48 (1972).

[49] *See id.*

[50] *See* SHAVELL, *supra* note 32, at 180-81.

[51] *30% x $1000 = $300.*

[52] *$0 (cost of care) + $300 (expected liability) = $300.*

[53] *$100 (cost of care) + $0 (expected liability) = $100.*

[54] *$200 (cost of care) + $0 (expected liability) = $200.*

[55] *See generally* John P. Brown, *Toward an Economic Theory of Liability*, 2 J. LEGAL STUD. 323-350 (1973); *see also generally* Steven Shavell, *Strict Liability versus Negligence*, 9 J. LEGAL STUD. 463-516 (1980).

[56] *See* SHAVELL, *supra* note 32, at 179-81; Brown, *supra* note 55, at 323-350.

B. *Level of Activity*

The level of activity refers to how many times a potential tortfeasor engages in the activity in question. It is important to look at the optimal level of activity when considering a change to the current tort regime, since the amount of a certain activity a potential tortfeasor conducts or participates in will ultimately have an effect on the efficiency of the system as a whole. An efficient tort regime would not want to incentivize the exercise of too much or too little of a particular activity. It is logical to conclude that the more a potential tortfeasor engages in a certain activity, the more likely it is for that person to commit a tort while engaging in that activity. It is also logical to conclude that the more a potential tortfeasor engages in a particular activity, the more utility or enjoyment he receives. The social goal then would be to maximize utility that potential tortfeasors gain from a particular activity minus the total social costs, which we developed above as the expected accident losses and the cost of the precautions.[57] What then is the level of activity that maximizes this social goal?

Assume that a potential tortfeasor, Blaster, under a strict liability scheme, sets off explosives on construction sites and in doing so takes the socially optimal, moderate level of care.[58] To engage in a particular activity once at this activity level, assume it costs Blaster $100 of precautions; if he engages in this activity twice it costs $200; if he engages in this activity three times it costs $300; if he engages in this activity four times it costs $400; and if he engages in this activity five times it costs $500. Assume that Blaster gains $1500 of total utility from engaging in the activity once; he gains $2400 from engaging in this activity twice; he gains $2900 from engaging in this activity three times; he gains $3400 from engaging in this activity four times; and, due to diminishing marginal utility,[59] he only gains $3300

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[57] *See* SHAVELL, *supra* note 32, at 193.

[58] As demonstrated above, a potential tortfeasor under a strict liability scheme is incentivized to take the socially optimal, moderate level of care. This is because by choosing the moderate level of care his expected accident losses are lower than if he took less than due care. The sum of the expected accident losses coupled with the cost of care or precautions still provides lower social costs than if he took no care or less than due care. *See* SHAVELL, *supra* note 32, at 179-81; *see also* Spano v. Perini Corp., 250 N.E.2d 31 (N.Y. 1969).

[59] *See* Yair Listokin & Kenneth Ayotte, *Protecting Future Claimants in Mass Tort Bankruptcies*, 98 NW. U. L. REV. 1435, 1461 (2004). The authors note:

> Economists generally believe that individuals experience diminishing marginal utility of money. That is, a dollar will bring more satisfaction to an individual when she is poor than when she is wealthy. For

from engaging in this activity five times. Further, assume that by taking the optimal level of care, the expected accident losses are reduced to the following amounts than if a lower standard of care were taken: if Blaster engages in the activity once, his expected accident losses are $500; twice, $1000; three times, $1500; four times, $2000; and five times, $2500. Thus, social welfare can be calculated by subtracting the cost of the precautions and the expected accident losses from the utility gained from each activity.[60] Thus, in this case, social welfare would be as follows: (1) $900 from engaging in the activity once; (2) $1200 from engaging in the activity twice; (3) $1100 from engaging in the activity three times; (4) $1000 from engaging in the activity four times; and (5) $300 from engaging in the activity five times. To maximize social welfare, a potential tortfeasor will choose the activity level where social welfare is highest. In this example, Blaster, exercising the optimal level of care, will engage in this activity twice, where $1200 provides the highest amount of social welfare.

The above example provides a basic theory[61] of achieving the optimal activity level under a strict liability scheme.[62] The results differ under both a no-liability and a negligence scheme. Under a no-liability tort scheme, the potential tortfeasor will continue to engage in the activity until he no longer gains utility.[63] This is because he does not take any care since doing so gives him no extra benefit and he will not be liable for any accident loss; thus, this is where social welfare is highest for this particular individual. Using the figures above, the potential tortfeasor engages in the activity four times, two more than the socially optimal level. The no-liability scheme, therefore, incentivizes a potential tortfeasor to not take the socially optimal level of care and to also engage in a particular activity too many times.[64]

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> example, an additional $20 to a poor person may allow them to purchase a new (and badly needed) pair of shoes. If the same person were very wealthy, however, the additional $20 might be devoted to purchasing a tenth pair of shoes. Because the first pair of shoes is more important to the individual than the tenth pair, $20 bring[s] greater satisfaction if the individual's wealth is smaller—implying that the "marginal utility" of money is decreasing.

*Id.*

[60] *See* SHAVELL, *supra* note 32, at 194-95.

[61] Professor Shavell first developed this theory in 1980. SHAVELL, *supra* note 32, at 463-488.

[62] *See* Jennifer Arlen, *Tort Damages,* 3500 ENCYCLOPEDIA OF LAW AND ECONOMICS 682, 684 (1999), *available at* http://encyclo.findlaw.com/tablebib.html.

[63] *See* SHAVELL, *supra* note 32, at 195.

[64] *See id.*

Like a potential tortfeasor facing no liability for his actions, a potential tortfeasor under the negligence rule will continue to engage in the activity until he no longer gains utility.[65] This is because such a potential tortfeasor is not liable for accident losses if he takes due care and thus does not take expected accident losses into account.[66] Therefore, his social welfare equals his total utility minus the total costs of care.[67] Using the figures above, this is at activity level four where total utility is at its highest. Notwithstanding Professor Shavell's characterization of this operation as being a "defect" and "failing" of the negligence rule because it does not incentivize a potential tortfeasor to take the socially optimal level of activity,[68] this exception makes sense and does not seem to be at all a paradox when conduct is properly categorized by the courts or the legislature.

If a potential tortfeasor under the negligence rule is acting with due care, a point where his behavior is not considered unreasonable, then lowering his activity level would lower his particular utility and, in turn, lower social utility when such activity is not inherently or abnormally hazardous. How then could Professor Shavell characterize the use of reasonable behavior as being excessive?[69] Such a characterization seems to be improper and only fitting where a tortfeasor is held liable for using less than due care. For example, it would be inefficient to discourage the use of leisurely automobile journeys merely because there was a chance that individual A could run into individual B in a non-negligent manner.[70] A tort scheme discouraging the continued pursuit of reasonable behavior up to level four using the figures above would be, in fact, inefficient.[71] On the other hand, incentivizing the reduction of an activity level to its optimal amount through strict liability appears to be an efficient solution to reducing damages caused by abnormally hazardous activities.[72]

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[65] *See id.* at 196.

[66] *See id.* at 196-97.

[67] *See id.* at 197.

[68] *See id.* at 198.

[69] *Id.* at 197.

[70] *See* DAVID D. FRIEDMAN, LAW'S ORDER 301 (2000).

[71] As Professor Shavell points out, a major problem with including the level of activity in the courts' negligence determination would be that courts would have to ascertain how many times a defendant participated in a certain activity in the past and would also have to piece together a standard activity level for certain types of conduct. Gathering such information would be extremely difficult and speculative. *See* SHAVELL, *supra* note 32, at 198.

[72] *See* FRIEDMAN, *supra* note 70, at 301.

### *IV. Optimal Level of Damages*[73]

As demonstrated in simplistic form above, the threat of liability that matches the level of harm, either through a rule of negligence or strict liability, will direct a party to take the socially optimal level of care and, in the case of strict liability, the socially optimal level of activity. In other words, if a tortfeasor is required to pay damages equal to the harm imposed upon the victim, potential tortfeasors will act at the socially optimal level of care.[74]

A more extensive example will demonstrate how this works even with multiple degrees of harm.[75] Consider the following example under the negligence rule: expected losses are represented as EL = $P_A(p_1 l_1 + p_2 l_2 + p_3 l_3)$, where $P_A$ represents the probability of an accident taking place if a potential tortfeasor does not take the socially optimal, moderate level of care, p represents probability and $l$ represents loss. A potential tortfeasor that chooses not to take the socially optimal, moderate level of care faces a 20% probability of an accident ($P_A$). If an accident does arise, there will be a loss ($l_1$) of $20,000 with a probability ($p_1$) of 55%, a loss ($l_2$) of $50,000 with a probability ($p_2$) of 30%, and a loss ($l_3$) of $100,000 with a probability ($p_3$) of 15%. A potential tortfeasor that takes the socially optimal, moderate level of care will completely eradicate any chance of an accident. If a potential tortfeasor chooses not to take the socially optimal, moderate level of care, his expected losses would therefore be $8200.[76] Assuming that a tortfeasor will be held liable for the full amount of losses that he causes through his negligence, whether that is $20,000, $50,000 or $100,000, a rational individual will choose to exert the socially optimal, moderate level of care if he can do so for less than $8200 since he can completely eliminate the possibility of paying any damages. Thus, this example solidifies the notion that if damages equal the full amount of harm caused by a tortfeasor, a potential tortfeasor will act at the socially optimal, moderate level of care even with multiple degrees of harm. This is because if a tortfeasor must pay for the actual harm caused, his expected damage payments, in this case, $8200, would be equal to the expected harm,

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[73] This article does not attempt to determine how uncertainty, court error, and a tortfeasor's ability to escape liability for losses affect optimal damage awards.

[74] *See* Arlen, *supra* note 62, at 685; Robert D. Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523-1560 (1984).

[75] *See* SHAVELL, *supra* note 32, at 236 (noting that optimality can be reached even when there are multiple levels of harm).

[76] *20% x (55% x $20,000 + 30% x $50,000 + 15% x $100,000) = $8200.*

also $8200.

The incentive to take the socially optimal, moderate level of care will be inadequate if expected damage payments are less than equal to harm.[77] Consider the following example using the same facts and numbers above except assume that there is a law in place that limits the damages a tortfeasor must pay to $25,000. Thus, even if actual harm exceeds $25,000, say $100,000, the tortfeasor will be liable for only $25,000. In this case, like before, if an accident does arise, there will be a loss of $20,000 with a probability of 55%, a loss of 50,000 with a probability of 30%, and a loss of $100,000 with a probability of 15%. Expected harm would again be $8200. However, expected damage payments would be much less at $4450.[78] This is because if an accident does arise, a tortfeasor will be liable for $20,000 with a probability of 55% and liable for $25,000 with a probability of 45%. Under such a $25,000 limitation, a potential tortfeasor will take only the optimal amount of care if he can do so for less than $4450 instead of whenever the cost is less than $8200.[79] If taking the socially optimal, moderate level of care costs $8100, a potential tortfeasor in this case will not be incentivized to take such care since his expected harm is much lower at $4450. He will be incentivized to take only care that costs less than $4450, which is $3750 less than expected harm.

Simply put, when expected damage payments are below expected harm, the expected damage payments do not serve as an incentive for a potential tortfeasor to take the socially optimal, moderate level of care.[80] Therefore, under such a scenario, more risky behavior will occur because potential tortfeasors are not incentivized to take the proper amount of risk.[81] Such potential tortfeasors are less incentivized to consider the complete range of consequences that could result from their conduct when liability is limited below the expected harm.[82] On the other hand, a potential tortfeasor will have the proper incentives to consider the complete range of consequences in his internal decision making prior to acting if a tortfeasor is required to pay damages equal to the damage

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[77] *See* SHAVELL, *supra* note 32, at 236.

[78] *20% x (55% x $20,000 + 45% x $25,000) = $4450.*

[79] *See* SHAVELL, *supra* note 32, at 238.

[80] *See id.* at 236. *See generally* Brown, *supra* note 55, at 323-350.

[81] Likewise, incentives to reduce risk will be too high if expected damage payments exceed actual harm, possibly to a point where a potential tortfeasor chooses not to engage in such proper conduct whatsoever. *See* SHAVELL, *supra* note 32, at 236-37.

[82] SHAVELL, *supra* note 32, at 239.

imposed upon the victim.[83]

## *V. Finding Optimality Through Game Theory*

Game theory is an economic model that analyzes strategic behavior[84] and offers powerful insights into how different legal rules affect the way individuals behave.[85] It analyzes strategic behavior in a way that simplifies the social setting and steps back from irrelevant details that cloud proper analysis.[86] Game theory will be used here to demonstrate how different liability rules affect a potential tortfeasor's decision to take the socially optimal, moderate level of care. Because a simple strategic problem involves the interaction of two individuals without knowing what the other party is doing,[87] this section will consider a bilateral model of torts, where both the potential tortfeasor and victim can take care and reduce risks of harm.

The model that will be used in this section is the normal form game, also known as the strategic form game.[88] It will analyze the interaction between a potential tortfeasor and a victim in three different legal regimes: (1) the tortfeasor is never liable; (2) the tortfeasor's liability is limited for negligence and a rule of contributory negligence is recognized; and (3) the tortfeasor is liable for negligence equal to the harm imposed upon the victim and a rule of contributory negligence is recognized. The normal form game has three elements: the players, the players' strategies, and the payoff that each player receives for each possible combination of strategies.[89]

The first regime (Regime A) that will be considered is where the tortfeasor is never liable. Assume the following: There are two players, the victim and the potential tortfeasor, both facing a binary choice—either to use no care or to use the socially optimal, moderate level of care. Exercising the socially optimal, moderate level of care costs $10; whereas, exercising no care costs $0. An accident imposes a cost of $100 on the victim. Moreover, an accident will happen unless both the victim and the potential tortfeasor exercise the socially optimum, moderate level of care. In this scenario, even if both exercise the optimal level of care, there is still a ten percent

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[83] *See* FRIEDMAN, *supra* note 70, at 206.

[84] ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 38 (4th ed. 2004).

[85] DOUGLAS G. BAIRD, ET AL., GAME THEORY AND THE LAW 1 (1994).

[86] *Id.* at 7.

[87] *See* BAIRD ET AL., *supra* note 85, at 1.

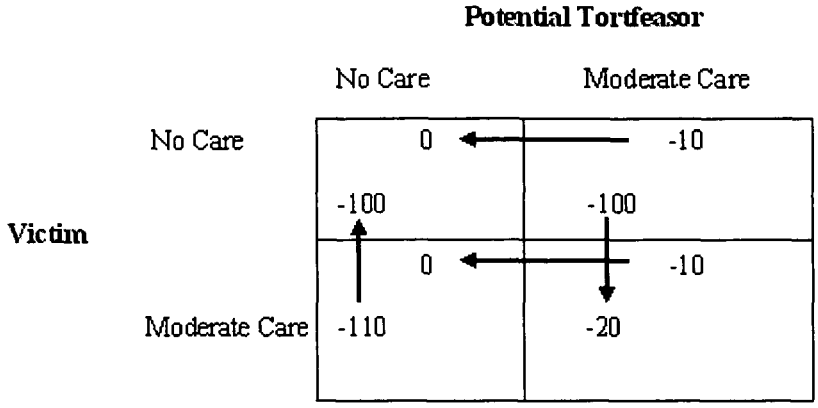
[88] *See id.* at 7-49 (providing a thorough explanation of the normal form game).

[89] *Id.* at 7-8.

chance of an accident taking place.

Figure 1 reveals the results of the game. As with all of the game theory figures in this article, the victim's payoffs are in the left hand column of each cell block and the potential tortfeasor's payoffs are in the right hand column of each cell block.

**Figure 1.** Regime A: The Tortfeasor is Never Liable.




In Regime A, the victim has no right to recover damages from the potential tortfeasor from an accident. If neither party exercises moderate care, the potential tortfeasor enjoys a payoff of $0 since he is not liable, and the victim must bear the costs of his own injuries and, thus, has a payoff of -$100. If both parties exercise moderate care, the potential tortfeasor has a payoff of -$10, which is the cost of moderate care, and the victim has a payoff of -$20, which is the cost of moderate care plus the ten percent chance of an accident. If the potential tortfeasor exercises moderate care and the victim does not exercise any care, the potential tortfeasor has a payoff of -$10, which is the cost of moderate care, and the victim has a payoff of -$100 since an accident is certain to occur. Lastly, if the victim exercises moderate care and the potential tortfeasor does not exercise any care, the potential tortfeasor has a payoff of $0, and the victim has a payoff of -$110, the cost of exercising care and the cost of the accident.

Once the payoffs are identified, it is time to solve the game.[90] Solving the game is accomplished by determining which strategies

[90] BAIRD ET AL., *supra* note 85, at 11.

the players are likely to choose.[91] In Regime A, the potential tortfeasor's choice of strategy is to always take no care regardless of what the victim does. This is his "dominant strategy."[92] The potential tortfeasor would not take care because it costs $10 to do so and he receives no benefit in return. The victim does not have a dominant strategy—his best course of action depends on what the potential tortfeasor does.[93] In sum, in a legal regime where a tortfeasor is never held liable, a potential tortfeasor will have no incentive to take care and will always choose to take no care.

The second regime, Regime B, is where the tortfeasor's liability is limited for negligence and a rule of contributory negligence is recognized. Assume the following: There are two players, the victim and the potential tortfeasor, both facing a binary choice—either to use no care or to use the socially optimal, moderate level of care. Exercising the socially optimal, moderate level of care costs $10; whereas, exercising no care costs $0. An accident imposes a cost of $100 on the victim. A recently enacted law limits a tortfeasor's liability for negligence to $5. However, the victim can recover $5 from the potential tortfeasor only if the potential tortfeasor is negligent, by using less than the moderate level of care, and the victim is not negligent, by using the moderate level of care. Moreover, an accident will happen unless both the victim and the potential tortfeasor exercise the socially optimal, moderate level of care. In this scenario, even if both exercise the optimal level of care, there is still a five percent chance of an accident occurring.

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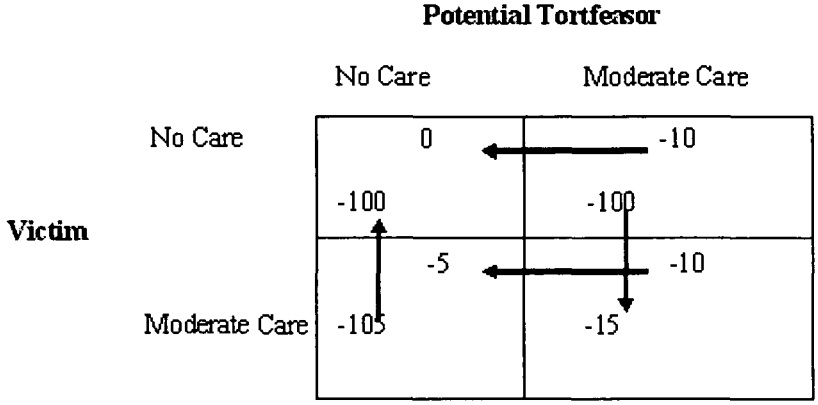
[91] *Id.* This article assumes that individuals are rational in that they choose the outcome that yields a higher payoff.

[92] Robert Cooter defines "dominant strategy" as "the optimal move for a player to make is the same, regardless of what the other player does." COOTER & ULEN, *supra* note 84, at 41. Baird defines "dominant strategy" as "a best choice for a player for every possible choice by the other player." BAIRD ET AL., *supra* note 85, at 11.

[93] *See* BAIRD ET AL., *supra* note 85, at 13.

Figure 2 reveals the results of the game.

**Figure 2.** Regime B: The Tortfeasor's Liability is Limited for Negligence and a Rule of Contributory Negligence is Recognized.




In Regime B, a tortfeasor's liability is limited to $5 where he is negligent and the victim is not. If both parties exercise no care, the potential tortfeasor has a payoff of $0 since he did not spend money on care and is not liable for the victim's injuries since the victim did not use care; the victim has a payoff of - $100, which reflects the costs of his injuries. If both parties exercise moderate care, the potential tortfeasor has a payoff of -$10, which is the cost of moderate care, and the victim has a payoff of -$15, which is the cost of moderate care plus the five percent chance of an accident. If the potential tortfeasor exercises moderate care and the victim exercises no care, the potential tortfeasor has a payoff of -$10, which is the cost of moderate care, and the victim has a payoff of -$100 since an accident is certain to occur and the potential tortfeasor is not negligent. Lastly, if the victim exercises moderate care and the potential tortfeasor does not exercise any care, the potential tortfeasor has a payoff of -$5, which is the amount that his liability is limited; whereas, the victim has a payoff of -$105, the cost of exercising moderate care, $10, and ninety-five percent of the cost of the accident, $95.

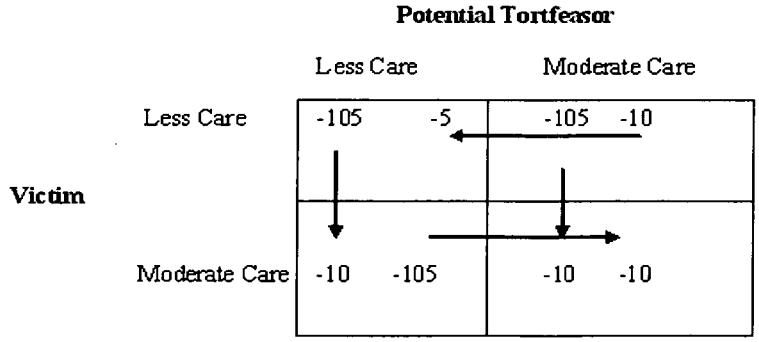
In sum, in Regime B, the potential tortfeasor's dominant strategy is again to take no care, regardless of what the victim does. This is his dominant strategy. The potential tortfeasor would not take moderate care because it is cheaper not to do so. If liability were not limited, then taking no care would not be the potential tortfeasor's

dominant strategy.[94] In this example, damage payments, $5, were set below harm, $100. This serves as another demonstration that when expected damage payments are below expected harm, the expected damage payments do not serve as an incentive for a potential tortfeasor to take the socially optimal, moderate level of care.

The third regime, Regime C, is where the tortfeasor is liable for negligence equal to the harm imposed upon the victim and the contributory negligence rule is recognized. Assume the following: There are two players, the victim and the potential tortfeasor, both facing a binary choice—either to use less than moderate care or to use the socially optimal, moderate level of care. Exercising the socially optimal, moderate level of care costs $10; whereas, exercising less than moderate care costs $5. An accident imposes a cost of $100 on the victim. The victim can recover from the potential tortfeasor only if the potential tortfeasor is negligent, by using less than the moderate level of care and the victim is not negligent, by using the moderate level of care. Moreover, an accident will happen unless both the victim and the potential tortfeasor exercise the socially optimal, moderate level of care. In this scenario, if both exercise the optimal level of care, there is a zero percent chance of an accident occurring.

Figure 3 reveals the results of the game.

**Figure 3.** Regime C: The tortfeasor is liable for negligence equal to the harm imposed upon the victim and the contributory negligence rule is recognized.




[94] *See id.* Like before, the victim does not have a dominant strategy. His best course of action depends on what the potential tortfeasor does.

In Regime C, the victim has a right to recover damages from the potential tortfeasor as the result of an accident only if the potential tortfeasor was negligent and the victim was not negligent. If both parties exercise less than moderate care, the potential tortfeasor enjoys a payoff of $5 for the cost of care and the victim must bear the costs of his own injuries, $100, since he was also negligent, plus the cost of care; thus, the victim has a payoff of -$105. If both parties exercise moderate care, the potential tortfeasor has a payoff of -$10, which is the cost of moderate care, and the victim has a payoff of -$10, which is the cost of moderate care. There is no accident when both parties exercise moderate care. If the potential tortfeasor exercises moderate care and the victim does not exercise any care, the potential tortfeasor has a payoff of -$10, which is the cost of moderate care, and the victim has a payoff of -$105, reflecting the cost of less care, $5, and the cost of the accident, $100. Lastly, if the victim exercises moderate care and the potential tortfeasor does not exercise any care, the potential tortfeasor has a payoff of -$105, the cost of the accident and of less care, and the victim has a payoff of -$10, the cost of exercising moderate care.

In sum, in Regime C, it is the victim that now has a dominant strategy. The victim will always be better off taking the socially optimal, moderate care. The potential tortfeasor no longer follows a dominant strategy. Whether the potential tortfeasor is better off taking moderate care depends on whether the victim chooses to take moderate care. Recognizing the victim's dominant strategy to choose moderate care, the potential tortfeasor will choose moderate care as well. Thus, this legal regime, where a tortfeasor is liable for negligence equal to the harm imposed upon a victim, results in both the victim and potential tortfeasor taking the socially optimal, moderate level of care.

Through the use of game theory, we have learned that in a legal regime where a tortfeasor is never held liable, a potential tortfeasor will have no incentive to take care and will always choose to take no care. We also have learned that even if a potential tortfeasor is held liable for negligence but expected damage payments are below expected harm, the expected damage payments do not serve as an incentive for a potential tortfeasor to take the socially optimal, moderate level of care. Game theory further revealed that both the victim and a potential tortfeasor would behave optimally in a legal regime where a tortfeasor is held liable for negligence equal to the

harm imposed upon a victim and a rule of contributory negligence is recognized. Any regime that does not incentivize optimal behavior will lead to either too many accidents or too much care in the form of costly investments by the potential victim.[95]

## *VI. Tort Reform Efforts*

### A. *The Call for Limiting Liability and Capping Damages*

With the apparent tort liability crisis plaguing the United States, there has been much ado about reforming the tort liability system. Many states have already passed tort reform legislation.[96] The efforts, however, are far from over. Medical malpractice liability reform, in particular, is at the top of the Bush Administration's domestic agenda.[97] A number of the proposed tort reform efforts, including medical malpractice liability reform, have focused on imposing damages caps or limiting the liability of a tortfeasor. As a case study, this section will examine the consequences from limiting liability in the medical malpractice setting. This section will focus only on the efforts to limit damages that an injured party can recover for his actual harm, including non-economic damages, but excluding punitive damages. Medical malpractice liability arises when a doctor or other health care professional commits an act of negligence or intentional tort.[98] A major component of the most recent legislative proposal to pass the U.S. House of Representatives is to cap non-economic damages that an injured party can receive to $250,000 in medical malpractice suits.[99] An examination of the results that would arise from limiting liability on legitimate medical malpractice claims, including non-economic damages, will reveal that a potential

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[95] BAIRD ET AL., *supra* note 85, at 14.

[96] For a complete fifty-state survey of caps on punitive damages and noneconomic damages in medical malpractice cases, see Cohen, *supra* note 18, *Medical Malpractice Liability Reform: Legal Issues and Fifty-State Survey of Caps on Punitive Damages and Noneconomic Damages* (2005).

[97] White House, Medical Liability, http://www.whitehouse.gov/infocus/medicalliability/ (last visited Mar. 18, 2007).

[98] *See* Cohen, *supra* note 18, at 2, *Medical Malpractice Liability Reform: Legal Issues and Fifty-State Survey of Caps on Punitive Damages and Noneconomic Damages.*

[99] H.E.A.L.T.H. Act of 2005, H.R. 5, 109th Congress (2005), (passed the U.S. House of Representatives on July 29, 2005 and imposes a $250,000 cap on noneconomic damages in any healthcare lawsuit "regardless of the number of parties against whom the action is brought or the number of separate claims or actions brought with respect to the same injury." Similar language has yet to passed by the Senate); *see also* White House, *supra* note 97.

tortfeasor is simply not given the ex ante incentives to behave at the socially optimal, moderate level of care and, consequently, the number of medical errors will increase. One positive trait of such reform is that the cost of care would decrease.

### B. *Consequences from Limiting Liability and Capping Damages: A Look at Medical Malpractice Liability Reform through the Lens of Economic Theory*[100]

#### 1. The Number of Medical Errors Will Increase

The concept at issue here is quite simple. If the price of something goes up, individuals buy less of that something. If the price of something goes down, individuals buy more of that something. Thus, for example, if the price of automobiles increases, individuals will purchase fewer automobiles. Likewise, if the price of risk increases, individuals will purchase less risk. What then will happen if there is a cap placed on the amount a plaintiff can recover in a medical malpractice suit for legitimate damages?

To find the answer, one must look at the basic principles of an efficient tort system that have been developed above. First, it has been established that under the general negligence rule, where a tortfeasor is held liable for the full cost of accident losses that he causes, a potential tortfeasor is incentivized to take the socially optimal, moderate level of care since doing so provides the least amount of cost to the potential tortfeasor.[101] Second, a potential tortfeasor will have the proper incentives to consider the complete range of consequences of his actions only if he is required to pay damages equal to the damages imposed upon the victim.[102] Thus, it is reasonable to conclude that if negligent health care professionals such as doctors are not held liable for the full amount of damages imposed upon a victim, there is simply no incentive to take the socially optimal, moderate level of care.

This conclusion still holds true with regard to noneconomic damages. "Non-economic damages," a term used by tort reform proponents, is another term for non-pecuniary losses. A non-pecuniary loss refers to the loss of utility when something

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[100] This article does not consider the effects of medical malpractice litigation or the reform of such, on the health care system and the insurance markets.

[101] *See supra* Part III.A.

[102] *See supra* Part IV.

irreplaceable is destroyed and includes pain and suffering and emotional distress.[103] This could range from the loss of a family heirloom to the loss of vision or a limb.[104] A pecuniary loss refers to a loss of money or a good that can be purchased in the market.[105] Both pecuniary and non-pecuniary losses are real damages that result in the loss of social welfare.[106] Damages payments, therefore, need to equal both pecuniary and non-pecuniary losses to properly incentivize a potential tortfeasor to take the socially optimal, moderate level of care.[107]

Admittedly, non-pecuniary losses are much more difficult to assess than pecuniary losses,[108] and the speculation of such losses could lead to inefficiencies.[109] However, this does not mean that non-pecuniary losses are less important than pecuniary losses and should

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[103] Professor Shavell describes non-pecuniary losses as: "[T]he losses in utility suffered when irreplaceable things have been destroyed, such as family portraits or other unique objects, or, importantly, injuries involving individuals' health, physical integrity, or emotional well-being." SHAVELL, *supra* note 32, at 242.

[104] According to the U.S. House of Representatives Energy and Commerce Committee Report: "Non-economic damages compensate patients for very real injuries such as the loss of a leg, disfigurement, pain and suffering, and the loss of fertility." H.R. REP. NO. 108-032, pt.2, at 39, (2003), (dissenting views).

[105] *See* SHAVELL, *supra* note 32, at 242.

[106] *See id.*

[107] *See* Lloyd Cohen, *Toward an Economic Theory of the Measurement of Damages in a Wrongful Death Action*, Vol. 34, NO. 2, 34 EMORY L.J. 295, 296 (1985). Cohen states:

> To achieve economic efficiency, it is necessary that potential tortfeasors have *ex ante* incentives to consider the costs their actions may impose on potential victims. To the extent that potential tortfeasors are aware of the judgments that are imposed on actual tortfeasors, they will treat the amount of those judgments as potential costs of their own contemplated and possibly tortious conduct. Therefore, the failure to make a just award in any particular tort action will *pari passui* to create disincentives for the world at large to take due care with the lives and property of others.

*Id.*

*See also* SHAVELL, *supra* note 32, at 242; Arlen, *supra* note 62, at 702 ("Optimal deterrence requires that injurers bear the full social cost of their risk taking activities, including nonpecuniary losses . . . ."); William Bishop & John Sutton, *Efficiency and Justice in Tort Damages: The Shortcomings of the Pecuniary Loss Rule*, 15 J. LEGAL STUD., 347-370 (1986).

[108] "Determining the amount of non-economic damages is an area traditionally subject to broad discretion on the part of juries . . . ." Cohen, *supra* note 18, at 3, *Medical Malpractice Liability Reform: Legal Issues and Fifty-State Survey of Caps on Punitive Damages and Noneconomic Damages* (2005).

[109] *See* Arlen, *supra* note 62, at 710; *see also* AMERICAN TORT REFORM ASSOCIATION (ATRA), TORT REFORM RECORD 29 (2003) ("ATRA believes that the broad and basically unguided discretion given juries in awarding damages for non-economic loss is the single greatest contributor to the inequities and inefficiencies of the tort liability system.").

be discounted as such. In other words, a loss of income is not necessarily more important than the loss of eyesight and long-term memory. Yet, under most tort reform proposals, a patient that suffered damages at the hands of a negligent doctor could recover for his lost income but could not necessarily recover for the full amount of his lost vision and long-term memory loss; the patient can recover only $250,000 in non-economic damages.[110] Such a cap seemingly punishes the worst injured; the more a victim is injured, the more the cap deprives him of full compensation.[111]

One solution for a more efficient scheme governing recovery for non-pecuniary losses may be to derive a statutory valuation of non-pecuniary losses ex ante that attempts to accurately reflect the loss imposed upon a victim.[112] For example, a loss of a leg could be valued at $100,000. These amounts can be adjusted up or down based on special individual factors or special circumstances in a way similar to how Federal Sentencing Guidelines for convicted criminals are adjusted.[113] Such a statutory valuation would solve the problem of juries engaging in mere conjecture of the value of a lost leg, for example, and could go a long way in eliminating the unevenness and unpredictability in damage awards. Moreover, it could also expedite settlement since a major obstacle to settlement is the disagreement over the amount of pain and suffering. Statutory valuation could also lead to lower insurance premiums since insurance companies now seem to charge higher premiums to counter the uncertainty of awards. Under the American Rule and current negligence scheme, juries seem inclined to overcompensate the victim to help restore the amount lost for attorneys' fees. Statutory valuation, as well as implementation of the English Rule, would eliminate that problem.[114] Most importantly, if no liability cap were in place and there were a proper set of statutory valuations, a potential tortfeasor would be properly incentivized to engage in the socially optimal, moderate level of care because he would be liable for the full amount of harm

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[110] *See* White House, *supra* note 97; Bill Mckelway, *New Caps Seen Not Happening*, RICHMOND TIMES DISPATCH, Jan. 19, 2005, at A1 (this article briefly discusses Virginia's attempt to cap damages in medical malpractice suits).

[111] Peter Perlman, *Don't Punish the Injured*, A.B.A.J., May 1986, at 34, 34. Perlman writes: "By forever freezing compensation at today's levels, caps discriminate against a single class of Americans whose members are destined to suffer a lifetime of depriviation of dignity and independence." *Id.*

[112] A commission made up of relevant experts, which conducts hearings and analyzes research, may be the best way to derive the various valuations.

[113] *See generally* U.S. SENTENCING GUIDELINES MANUAL (2006).

[114] Statutory valuation, with the combination of a fee shifting scheme, would be a powerful punch in creating an efficient tort system.

imposed upon the victim.

In sum, if a healthcare professional will not be held accountable for the full amount of the injuries that he negligently imposes on a patient, both pecuniary and nonpecuniary losses, he will not be incentivized to take the proper amount of risk and act at the socially optimal, moderate level of care. Therefore, based on the conclusions developed in sections III and IV above, it is fair to conclude that medical errors will increase if a cap on damages is imposed in all medical malpractice suits.[115]

2. The Cost of Medical Care Will Decrease.

One positive trait associated with limiting the liability of health care professionals would be the decrease in the cost of medical care. Because of the uncertainty of non-pecuniary damage awards under the current scheme, doctors include a premium in the price of their services. This has an enormous impact on the price in medical care. Potential tortfeasors simply build in the expected, but yet uncertain, cost of judgment in their own contemplated and possibly tortious conduct, which effectively raises the price of the product or service that the patient purchases. Patients, then, ultimately pay the price in increased medical costs.

If, however, a statutory cap were set in place on non-pecuniary damages, the supply of doctors would increase because the amount doctors would have to pay in the event of negligence would decrease.[116] The increase in the supply of doctors would drive the price of services down through competition.[117] A statutory valuation of non-pecuniary losses, however, would have the same effect. Assuming that the statutory valuation of such losses reflects actual losses, under the current negligence scheme tortfeasors would be liable for the actual damages imposed upon the victim, not an

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[115] It is probably important to note that the social optimality achieved under a general negligence rule scheme where a potential tortfeasor is liable for the full amount of damages caused by his negligence does not change when a doctor, for example, purchases medical malpractice insurance. A doctor would not purchase the insurance simply to act negligently because the price of insurance would cost too much. *See* SHAVELL, *supra* note 32, at 264-65.

[116] *See* Jonathan Klick & Thomas Stratmann, *Does Medical Malpractice Reform Help States Retain Physicians and Doest It Matter?* 17 (Dec. 15, 2005) (unpublished working paper, on file with the Social Science Research Network (SSRN)), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=870492&high=%20Medical%20Malpractice%20Reform%20Klick (suggesting that malpractice reforms, particularly caps on nonpecuniary damages, are effective in attracting and retaining physicians).

[117] *See* COOTER & ULEN, *supra* note 84, at 33-34.

inflated amount. Potential tortfeasors would then know the full consequences of their contemplated conduct and would charge patients accordingly, at a lower premium than the one imposed under the current scheme where doctors have to compensate for uncertain judgments. Thus, statutory valuation would also lead to an increase in the supply of doctors and a decrease in the cost of medical care. The amount doctors would have to pay in the event of negligence would decrease to the point of actual damages, which would lead to more doctors in the industry, and the competition would ultimately lead to a lower price for medical services.

### *VII. Maximizing Social Welfare: Finding the Tort Reform Best Solution*

The goal of the law should be to maximize the welfare of society.[118] There are three known efficiency criteria to determine when this goal is met: the Pareto criterion, the Kaldor-Hicks criterion, and the Nash-Rawls criterion.[119] A state of the world is Pareto efficient if no individual's utility can be increased without decreasing another individual's utility.[120] In other words, in the tort context, a tortfeasor's risk taking must leave no one worse off than he was in the status quo.[121] A state of the world is Kaldor-Hicks efficient when it is impossible to increase anyone's utility so that the winners could compensate the losers.[122] In other words, if parties that benefit from a particular change can compensate the losers from the change and still come out ahead then the change is a Kaldor-Hicks improvement.[123] There is no requirement for actual compensation.[124] Under the Nash-Rawls criterion, a tort rule is efficient if the total

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[118] *See* Arlen, *supra* note 62, at 682-83.

[119] *See id.*; Francisco Parisi, *Positive, Normative and Functional Schools in Law and Economics*, 18 EUR. J.L. & ECON. 259, 267-272 (Winter 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586641&high=%20Law%20and%20Economics%20Parisi.

[120] *See* Arlen, *supra* note 62, at 682-83. Vilfredo Pareto is responsible for this criterion. He was an Italian economist, political scientist, and sociologist at the turn of the twentieth century. *See* COOTER & ULEN, *supra* note 84, at 16 n.1; Parisi, *supra* note 119, at 13.

[121] *See* COOTER & ULEN, *supra* note 84, at 16-17.

[122] *See* Arlen, *supra* note 62, at 683; Parisi, *supra* note 119, at 14-15.

[123] *See* COOTER & ULEN, *supra* note 84, at 48.

[124] Parisi, *supra* note 119, at 15. Parisi also notes that "if actual compensation was carried out, any test satisfying the Kaldor-Hicks criterion of efficiency would also satisfy the Pareto criterion." *Id.* at 15 n.8.

utility of society is maximized.[125] This holds true even if some individuals are made worse off by the change.[126] What matters under Nash-Rawls is whether society as a whole gains utility.[127] Although the Pareto criterion analysis seems to be the most appropriate approach in analyzing efficiency when contemplating a change to the tort system, this section will analyze whether a change from the existing tort scheme, under a rule of negligence, to a scheme that limits a defendant's liability or to a scheme that recognizes the English Rule would be efficient under any of the three efficiency criteria.

### A. *Pareto Criterion*

To meet the Pareto efficiency criterion, the risk-taking level adopted by the potential tortfeasor must leave no other individuals worse off than they are in the status quo. Damage payments under Pareto must leave potential victims no worse off than they would be under the status quo. The current negligence scheme is Pareto efficient because it requires tortfeasors to fully compensate victims, who are entitled to freedom from harm caused by unreasonable risks, for the full harm imposed upon the victims, leaving victims no worse off. By limiting the amount of damages, a tortfeasor must pay to the victim below the actual damages imposed upon the victim, a victim is not made whole and is, therefore, made worse off. Thus, a change from the general negligence scheme, where a victim is fully compensated by the tortfeasor for the full extent of the victim's damages, to a scheme where liability is capped below actual damages is not a Pareto efficient change.

On the other hand, a change from the general negligence scheme, like the American Rule, to a fee-shifting scheme, like the English Rule, is a Pareto efficient change. Under the American Rule, a victim is responsible for his own litigation costs notwithstanding a victory. Thus, an American Rule victim is not made completely whole in the sense that a portion of his winnings goes towards attorneys' fees. Moreover, an American Rule defendant who is found to be free from negligence is not made whole since he must pay to defend the suit and is not reimbursed despite being found not liable. A change from the American Rule to the English Rule shifts litigation costs to the losing party, thereby leaving the winning party no worse than

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[125] Arlen, *supra* note 62, at 683; Parisi, *supra* note 119, at 15-17.
[126] Arlen, *supra* note 62, at 683; Parisi, *supra* note 119, at 17.
[127] Parisi, *supra* note 119, at 17.

before the suit, and more accurately encapsulates the tortfeasor's full cost of risk creation.[128] Thus, a change from the American Rule to the English Rule is a Pareto efficient change. This change is also consistent with Mitchell Polinsky and Daniel Rubinfield's view of optimal deterrence, which requires that tortfeasors compensate victims for their litigation costs.[129]

B. *Kaldor-Hicks Criterion*

To meet the Kaldor-Hicks criterion, tortfeasors that benefit from a change from the general negligence scheme to one where damages are capped at a statutory amount, possibly even below actual damages, must be able to compensate the victims monetarily for their losses from the tort and still come out ahead, although actual compensation is not required. Such a change would not be a Kaldor-Hicks improvement because if such compensation were actually made, a tortfeasor would not come out ahead but would have only enough to compensate the other party. For example, suppose that a victim's actual damages were $600,000 and there was a statutory cap on damages for the amount of $250,000. In such a case, the victim is made worse off by the cap for the amount of $350,000. If the tortfeasor hypothetically paid the victim an additional $350,000 to compensate for the victim's monetary loss, the tortfeasor would still be in the same position under the current negligence scheme and would, therefore, not come out ahead, not even by one dollar. The two schemes under Kaldor-Hicks are indistinguishable from an efficiency standpoint; the amount of money available remains unchanged. Thus, a change from the general negligence scheme, where a victim is fully compensated by the tortfeasor for the full extent of the victim's damages, to a scheme where liability is capped below actual damages is not a Kaldor-Hicks efficient change.[130]

A change from the American Rule to the English Rule seems to yield the same results under Kaldor-Hicks and would be deemed an inefficient change since the losing party would then be responsible for the winning party's attorneys' fees. The party that benefits from the change, the winner, would not be able to compensate the losers for his losses, the payment of the winning party's litigation costs, and still come out ahead since it would just be an exchange of attorneys'

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[128] Arlen, *supra* note 62, at 691, 719.

[129] *See generally* Mitchell A. Polinsky & Daniel Rubinfeld, *The Welfare Implications of Costly Litigation for the Level of Liability*, 17 J. LEGAL STUD. 151 (1988).

[130] Parisi, *supra* note 119, at 15-16.

fees and would effectively cancel out like above. However, such an analysis under Kaldor-Hicks would be flawed since the starting presumption in that scenario is that a losing party should not have to pay the winning party's attorneys' fees. By appropriately taking away that entitlement, the fully compensated litigation costs for the winners becomes an extra amount and allows for the compensation from the winner to the loser, with the ability of the winners still being able to come out ahead. For example, suppose that under such a non-entitlement scenario a winner victim's litigation costs are $25,000 and he hypothetically compensates the loser one dollar, therefore being left with $24,999. Any compensation, including one dollar, from the winning victim to the losing tortfeasor would be an amount below the full cost of risk creation[131] on the part of the tortfeasor, effectively serving as a bonus of sorts since the losing tortfeasor did not lose from the change, and would still allow the winning victim to come out ahead since under the American Rule a winning party cannot receive compensation for his attorneys' fees absent special circumstances. Thus, a change from the American Rule to the English Rule would be a Kaldor-Hicks efficient change under the presumption that the losing party is not entitled to not have to pay the winning party's attorneys' fees.

### C. *Nash-Rawls Criterion*

To meet the Nash-Rawls criterion for efficiency under a change from the general negligence rule to a scheme where damages are capped at a statutory amount possibly even below actual damages, it is essential only that society as a whole gains, even if that results in a party being made worse off because of such gain. Because there is no change in the amount of money available in a shift from the general negligence rule to a rule where damages are capped at a statutory amount, such a schematic change would not be Nash-Rawls efficient since society as a whole would not gain and society would in fact be indifferent to such a change. A change from the American Rule to the English Rule, on the other hand, would in fact be Nash-Rawls efficient under the presumption that the losing party is not entitled to not have to pay the winning party's attorneys' fees. Under such a scenario the amount the losing party has to pay is considered an additional sum; therefore, society as a whole gains.

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[131] The full cost of risk creation should include litigation costs of the plaintiff. Arlen, *supra* note 62, at 719.

## *VIII.A Comparative and Historical Look at the American Rule and the English Rule*

As discussed supra, there are two general approaches to fee-shifting, commonly known as the American Rule and the English Rule. There are, of course, different variations of the two rules throughout different jurisdictions, but the two general approaches to fee-shifting remain simple and will be the focus of this article.[132]

### A. *The American Rule*

The American Rule has been the general practice in the United States "as far back as one can trace."[133] Professor Albert A. Ehrenzweig, however, claims that the English Rule was originally adopted in the American colonies but was somehow lost, calling it the "gradual forgetting" of the more efficient English Rule.[134] Professor Ehrenzweig goes on to say that the American Rule's adoption in the United States is attributable to a pure historical accident.[135] Whether it was an historical accident or not, the United States Supreme Court has been quite clear on the fee-shifting issue since 1796. In the 1796 case, *Arcambel v. Wiseman*, the Court ruled that it would not create a general rule independent of any statute permitting the award of attorneys' fees to the prevailing party, holding: "The general practice of the United States is in opposition [sic] to it; and even if that practice were not strictly correct in principle, it is entitled to the respect of the court, till it is changed, or modified, by statute."[136] Since the *Arcambel* decision, the Supreme Court has strictly adhered to that holding.[137] There have been, of course, statutory

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[132] For the purposes of this article, unless otherwise stated, the English Rule will be treated as requiring the losing party to pay all of the winning party's legal fees.

[133] For a discussion of the history of the American Rule, see John Leubsdorf, *Toward a History of the American Rule on Attorney Fee Recovery*, 47 LAW & CONTEMP. PROBS. 9 (Winter 1984). Leubsdorf conducts quite a thorough analysis on the history of the American Rule. *Id.*; *see also* Pfennigstorf, *supra* note 25, at 40 (recognizing that "it has been [quite] difficult . . . to find a clear statement of the reasons why the [American] courts have chosen to leave attorney fees and other expenses at the charge of each party.").

[134] Albert A. Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CAL. L. REV. 792, 799 (1966).

[135] *Id.* at 798-99; David T. Schaefer, *Attorney's Fees for Consumers in Warranty Actions—An Expanding Role for the U.C.C.?*, 61 IND. L.J. 496, 498 n.18 (1986).

[136] Arcambel v. Wiseman, 3 U.S. (3 Dall.) 306 (1796).

[137] *See, e.g.*, Day v. Woodworth, 13 How. 363, 14 L.Ed. 181 (1852); Oelrichs v. Spain, 15 Wall. 211, 21 L.Ed. 43 (1872); Flanders v. Tweed, 15 Wall. 450, 21 L.Ed.

modifications and exceptions to this rule throughout the United States, but the general practice is that the "prevailing litigant is . . . not entitled to collect a reasonable attorneys' fee from the loser."[138] There is no doubt that on the international level the American Rule serves as the exception rather than the rule.[139]

### B. *The English Rule*

In civil law countries and the United Kingdom, the English Rule is the general approach taken in tort litigation.[140] The derivation of the English Rule seems to have come from England, where as early as 1278 the courts were authorized to award attorney fees to successful litigants.[141] In most civil law countries the codes specifically require courts to impose costs, inclusive of attorneys' fees, on the defeated party.[142] For example, Article 696 of the French Code requires that "[c]osts are assessed against the losing party unless the judge assesses

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203 (1873); Stewart v. Sonneborn, 98 U.S. 187 (1879); Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714 (1967); F.D. Rich Co. v. United States ex rel. Industrial Lumber Co., 417 U.S. 116 (1974); Alyeska Pipeline Service Co. v. Wilderness Soc'y, 421 U.S. 240 (1975).

[138] Alyeska Pipeline Service Co., 421 U.S. at 247. The typical variation or departure from the American Rule in the United States is typically to a one-way fee shifting scheme, where a winning plaintiff can recover attorneys' fees from the defendant if the plaintiff is successful but a successful defendant cannot recover attorneys' fee from a losing plaintiff, such as the Equal Access to Justice Act (28 U.S.C. § 2412(d) (2003)). *See* Kritzer, *supra* note 22, at 1946, 1947. Several states have also enacted similar one-way fee shifting statutes. *See id.* at 1947 (citing Susan M. Olson, *How Much Access to Justice from state 'Equal Access to Justice Acts'?*, 71 CHI.-KENT L. REV. 547, 556-57 (1995)). The State of Alaska's Rule 82 actually provides for a two-way fee shifting scheme although it works much differently than the traditional English Rule scheme. Alaska Rule of Civil Procedure 82 provides: "Except as otherwise provided by law or agreed to by the parties, the prevailing party in a civil case shall be awarded attorneys' fees calculated under this rule." AK Rules of Civil Procedure, Rule 82 (2003). However, Alaska's Rule 82 only entitles the prevailing party in a civil lawsuit to partial compensation of his attorneys' fee from the losing party. For example, for a contested trial suit, a winning party that recovers a money judgment can receive 20% of that judgment for the first $25,000 and 10% of the judgment beyond $25,000. For a more detailed analysis of the Alaska approach see generally Di Pietro & Carns, *supra* note 20.

[139] Pfennigstorf, *supra* note 25, at 37.

[140] *See id.* at 37, 38, 44-46; *see also* Kritzer, *supra* note 22, at 1946.

[141] *See* Alyeska Pipeline Service Co., 421 U.S. at 247 n.18.

[142] *See, e.g.*, ABGB [CIVIL CODE] § 41 (Austria); [CIVIL CODE] art. 1017 (Belgium); CODE OF CIVIL PROCEDURE § 312 ¶ 1 (Den.); CODE CIVIL [C. CIV.] art. 696 (Fr.); BGB [CIVIL CODE] § 91 (F.R.G.); C.C. art. 91 (Italy); BW [CIVIL CODE] art. 56 (Holland); [Civil Code] § 172 (Norway); RB [CODE OF CIVIL PROCEDURE] 18:1 (Swed.). Although not always stated specifically in the code, the fee-shifting rule applies whether a party is a plaintiff or defendant. Pfennigstorf, *supra* note 25, at 37, 46.

the whole or a part of the burden against the other party, in a decision with reasons given."[143] Section 41 of the Austrian Code states, "The party that loses completely in the litigation must reimburse the opponent, as well as party intervening on the latter's side, for all costs that were caused by the litigation and were necessary for appropriate prosecution or defense."[144] Section 91 of the German Code states that "(1) the losing party must bear the costs of the litigation, and must in particular reimburse the costs incurred by the opponent insofar as they were necessary for appropriate assertion or defense of rights. . . . (2) The statutory fees and expenses of the attorney for the prevailing party must be reimbursed in all proceedings . . . ."[145] Article 56 of the Netherlands Code states, "Anyone who is defeated by judgment shall have the costs imposed on him." Article 91 of the Italian Code states that "the judge shall order the defeated party to reimburse the other party for the costs, and shall also assess the amount of the costs, as well as that of the honorarium of the attorneys."[146]

In England, the courts are given discretion whether to rule on costs,[147] but in practice this discretion is limited.[148] Section 51 of the Supreme Court Act specifically states that the "court shall have full power to determine by and whom and to what extent the costs are to be paid."[149] The Rules of the Supreme Court and case law limit an English court's discretion. These Rules state that a court shall "'order the costs to follow the event,' unless the circumstances justify a different allocation."[150] English case law further limits discretion by stating that "where a plaintiff comes to enforce a legal right, and there as been no misconduct on his part . . . the court has no discretion, and cannot take away the plaintiff's right to the costs."[151]

Of the codes mentioned above, Austria, Germany, and the Netherlands are the most rigid and do not allow the courts to impose discretion in allocating costs.[152] Other countries give the courts a

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[143] CODE CIVIL [C. CIV.] art. 696 (Fr.).

[144] ABGB [CIVIL CODE] § 41 (Austria).

[145] BGB [CIVIL CODE] § 91, ¶¶ 1-2 (F.R.G.).

[146] C.C. art. 91 (Italy).

[147] Senior Courts Act, 1981, c. 54, § 51 (Eng.).

[148] Pfennigstorf, *supra* note 25, at 37, 45 n.43.

[149] Senior Courts Act, 1981, c. 54, § 51 (Eng.).

[150] CIVIL PROCEDURE RULES, 1998, Order 62, r.3(2) (Eng.); Pfennigstorf, *supra* note 25, at 37, 47.

[151] Cooper v. Whittingham, 15 Ch. D. 501 (1880); *see* Pfennigstorf, *supra* note 25, at 37, 47, 48.

[152] *See* Pfennigstorf, *supra* note 25, at 37, 47. A full discussion of efficient

little more flexibility. For example, the Italian Code allows the court to "exclude reimbursement of costs incurred by the prevailing party if he considers them excessive or superfluous . . . ."[153] The Judicial Code of Denmark, section 312, provides: "The losing party is obligated to reimburse the opposing party for the costs caused by the litigation, except insofar as the parties have agreed otherwise, or the court for special circumstances finds it equitable to deviate from the rule."[154]

Several countries permit qualifications and exceptions to the hard and fast fee-shifting rule for special situations.[155] For example, Sweden allows for an exception to the fee-shifting rule when the losing defendant did not provoke the plaintiff's action and recognized the plaintiff's claim immediately, rendering the action unnecessary. Alternatively, an exception exists when the plaintiff prevails on material facts that the losing defendant did not or could not know prior to the commencement of the action.[156] An important qualification on the fee-shifting rule is that the prevailing party is entitled to reimbursement for only those costs that were necessary to obtain a favorable verdict.[157] This rule discourages the use of unnecessary and uneconomical procedural acts or motions and is followed by Austria, Denmark, England, Germany, and other countries.[158]

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qualifications and exceptions to the fee shifting rule are beyond the scope of the article.

[153] C.C. art. 92 (Italy).

[154] CODE OF CIVIL PROCEDURE § 312, ¶ 1 (Den.); *see also* C. CIV. art. 696 (Fr.).

[155] *See* Pfennigstorf, *supra* note 25, at 37, 49.

[156] RB [CODE OF CIVIL PROCEDURE] 18:3 (Swed.); *see* Pfennigstorf, *supra* note 25, at 37, 49.

[157] Pfennigstorf, *supra* note 25, at 37, 51.

[158] ABGB [CIVIL CODE] § 41 (Austria); CODE OF CIVIL PROCEDURE § 312, ¶ 2 (Den.); CIVIL PROCEDURE RULES, 1998, Order 62, r. 28(2) (Eng.); BGB [CIVIL CODE] § 91, ¶ 1 (F.R.G.). See Pfennigstorf, *supra* note 25, at 37, 54 n. 112 for a listing of other countries that use other methods to control the amount of reimbursable costs. This is consistent with the way attorneys' fees are administered under certain one-way fee shifting statutes in the United States. 42 U.S.C. § 1988 (2000) states: "In any action or proceeding to enforce a provision of sections . . . 1983 . . . the court, in its discretion, may allow the prevailing party . . . a reasonable attorney's fee as part of the costs." The United States Supreme Court has adopted the lodestar figure as the measure of the "reasonable fee" to which a prevailing party is entitled under § 1988. City of Burlington v. Dague, 112 S. Ct. 2638, 2641 (1992) ("The 'lodestar' figure has . . . become the guiding light of our fee-shifting jurisprudence."). (The lodestar formula was first set forth in *Lindy Bros. Builders, Inc. v. Am. Radiator & Standard Sanitary Corp.*, 487 F.2d 161, 167 (3rd Cir. 1973)). The lodestar figure "is the number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate." Hensley v. Eckerhart, 103 S. Ct. 1933, 1939 (1983). Thus, there are two prongs to the lodestar calculation: (1) the number of hours the attorney reasonably

## *IX. Economic Theoretical Analysis of Fee-shifting*

### A. *Deciding Whether toFile and the Filing of Frivolous and Weak Lawsuits*

A simple economic analysis of the two general approaches to fee-shifting demonstrates that, assuming all parties act rationally, American Rule plaintiffs are more likely to file suits that are frivolous or have a low probability of victory than English Rule plaintiffs.[159]

#### 1. Choosing to File

Under the American Rule, a plaintiff will file suit only *if* his expected judgment is at least as large as his legal costs.[160] This is represented as $P_w \times A > C$, where $P_w$ represents the probability of the plaintiff prevailing at trial,[161] $A$ represents the prevailing award amount, and $C$ represents the legal costs of the litigation. Consider the following example of a plaintiff filing suit under the American Rule:[162]

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expended on the litigation; and (2) the attorneys' reasonable hourly rate for the services performed. In *Blum v. Stenson*, the Supreme Court stated that the figure that results from the lodestar calculation is more than a mere rough guess or initial approximation of the final award to be made: "[w]hen, however, the applicant for a fee has carried his burden of showing that the claimed rate and number of hours are reasonable, the resulting product is presumed to be the reasonable fee . . . ." Blum v. Stenson, 104 S. Ct. 1541, 1548 (1984); *see also* City of Burlington, 112 S. Ct. at 2641 ("We have established a 'strong presumption' that the lodestar represents the 'reasonable fee.'"). Simply put, the fear that large corporations will run up unreasonably large legal bills is unfounded and should not be accepted in any fee shifting approach adopted in the United States.

[159] The article assumes throughout that all parties act rationally. This is consistent with the standard economic theory of litigation models developed by Landes, Posner, and Gould that depict "litigating parties as rational actors who seek to maximize their returns from the litigation process." Katz, *supra* note 30, at 67; *see, e.g.*, William M. Landes, *An Economic Analysis of the Courts*, 14 J.L. & ECON. 61 (1971); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973); John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973).

[160] *See, e.g.*, Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 35, 58-60 (1982); Katz, *supra* note 30, at 71. However, it goes without saying that a plaintiff is more likely to file suit if his expected judgment is more than his legal costs.

[161] This article does not address how the plaintiff's estimate of the probability of victory is determined. For such an analysis see Keith N. Hylton, *Fee Shifting and Incentives to Comply with the Law*, 46 VAND. L. REV. 1069, 1081-1089 (1993).

[162] *See, e.g.*, Shavell, *supra* note 160, at 58-60; *see also* Katz, *supra* note 30, at 71.

> **(Example A).** The plaintiff's legal costs from filing suit all the way to the end of a trial are $10,000 ($C$).[163] The plaintiff believes that if he prevails at trial he will be awarded $100,000 ($A$). On the advice of counsel, the plaintiff believes that he has a 19% chance of prevailing at trial ($P_w$). The plaintiff then decides to file suit since his expected judgment from a trial would be $19,000,[164] which would exceed his legal cost of $10,000. On the other hand, if the plaintiff believes that he has a 9% chance of prevailing at trial, the plaintiff does not file suit since his expected judgment from a trial would be $9000,[165] $1000 less than his legal costs.

Under the English Rule, a plaintiff will similarly file suit in a particular case only *if* his expected judgment is as least as large as his legal costs.[166] Under this rule, however, the plaintiff's total legal costs include the defendant's total legal costs if the plaintiff loses at trial; if the plaintiff wins at trial, he incurs no legal costs.[167] Thus, in calculating the value of bringing suit, the total legal costs must be discounted by the probability of losing at trial.[168] This is represented as $P_w \times A > P_L \times (C_P + C_D)$. The variables denote the following: $P_w$ represents the probability of the plaintiff prevailing at trial; $P_L$ represents the probability of the plaintiff losing at trial; $A$ represents the prevailing award amount; $C_P$ represents the plaintiff's legal costs of the litigation; and $C_D$ represents the defendant's legal costs of the litigation. Consider the following example of a plaintiff filing suit under the English Rule:[169]

> **(Example B-1).** The plaintiff's legal costs from filing suit all the way to the end of a trial are $10,000 ($C_P$). The defendant's legal costs will be $15,000 ($C_D$). The plaintiff believes that if he prevails at trial he will be awarded $100,000 ($A$). On the advice of counsel, the plaintiff believes that he has a 19% chance of prevailing at trial ($P_w$) and thus an 81% chance of losing at trial ($P_L$). Therefore, if the plaintiff believes that his probability of prevailing is 19%, his expected award of $19,000 would not

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[163] The author assumes for the sake of the hypothetical examples throughout this article, unless otherwise stated, that the case ends at trial and cannot be appealed.

[164] The formula is computed as follows: $0.19 \times \$100,000 > \$10,000$.

[165] The formula is computed as follows: $0.9 \times \$100,000 < \$10,000$.

[166] *See* Shavell, *supra* note 160, at 58-60.

[167] *See id.*

[168] *See id.*

[169] *See id.*

exceed his expected legal costs of $20,250.[170] Consequently, unlike under the American Rule, the plaintiff will not file suit in this case.[171]

A simple comparison of the two general approaches to fee-shifting demonstrates that the American Rule encourages plaintiffs with a low probability of victory to file suit and the English Rule actually discourages such filings.[172] As discussed above, when a

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[170] The formula is computed by taking the percentage chance of losing and multiplying that number by the total costs of legal fees, which is done as follows: *81% x $25,000.*

[171] The English Rule also discourages the filing of an ex ante perceived less-than-average suit because it emboldens the defendants to put up a more costly defense. The mere inherent threat of the bolstering of the defense further discourages the filing of these types of suits under the English Rule because it increases the Plaintiff's expected legal costs in the event the Plaintiff loses. *See* Katz, *supra* note 30, at 71; David Rosenberg & Steven Shavell, *A Model In Which Suits are Brought for Their Nuisance Value*, 5 INT'L L. REV. OF L. AND ECON. 3-13 (1985).

[172] Katz, *supra* note 30, at 71. Professor Steven Shavell claims that the frequency of filing stronger suits is likely greater under the English Rule. Shavell claims "[t]his is so because when the plaintiff is relatively optimistic about prevailing [ex ante], his expected legal costs will be relatively low under the [English Rule.]" *See* Shavell, *supra* note 160, at 58-60. For example under Shavell's line of thinking (Example B-2), under Example B-1, if the plaintiff believes that his likelihood of success at trial is 80%, his expected legal costs are $5000. (This is computed as follows: *0.80 x $100,000 > 0.20 x ($10,000 + $15,000) = $80,000 > $5000.*) Moreover, the English Rule plaintiff is also thinking about the possibility of paying no legal costs at all. Shavell, *supra* note 160, at 58-60. Conversely, under the above American Rule example, the plaintiff must bear his own legal costs of $10,000 with absolute certainty, except under contingent fee arrangements. *Id.* Professor Avery Katz has also pointed out that the English Rule promotes the filing of tort claims where the stakes are extremely low but where there is a high ex ante probability of victory, unlike the American Rule. Katz, *supra* note 30, at 71. Katz also argues that the American Rule actually discourages the filing of cases whatsoever when the stakes are low. *Id.* Consider the following example under the English Rule:

> **(Example C).** The plaintiff's legal costs from filing suit in small claims court to the end of a bench trial are $500 ($C_p$). The defendant's legal costs would also be $500($C_D$). The plaintiff believes that if he prevails at trial he would be awarded $50 ($A$). Plaintiff believes that he has a 98% chance of prevailing at trial ($P_w$) and thus a 2% chance of losing at trial ($P_L$). Therefore, the plaintiff will file a tort claims against the defendant since the plaintiff's expected award of $49 would exceed his expected legal costs of $20. (This is computed as follows: *0.98 x $100 > 0.02 x ($500 + $500) = $49 > $20.*)

A plaintiff under the American Rule would not file the above suit since the plaintiff's expected award of $49 would not exceed his expected legal costs of $500. (This is computed as follows: *0.98 x $100 > $500 = $49 > $500.* Here, $49 is not greater than $500 so the American Rule plaintiff will not file suit.) Encouraging the filing of better-than-average suits in cases where there is little at stake leads to an efficient result. (According to Cooter and Ulen, "[w]hen the marginal social cost of precaution is less than the marginal social benefit, efficiency requires taking more

plaintiff is not optimistic about his chances, he is more likely to file suit under the American Rule.[173] This is compounded under a contingency fee arrangement.[174] In such a case, the American Rule plaintiff bears no burden of legal costs. Consider the following example under a contingency fee arrangement, which is the prevailing fee arrangement in tort cases under the American Rule:[175]

> **(Example D-1).** Plaintiff's legal costs, excluding attorneys' fees, from filing suit all the way to the end of a trial will be $3000, which, as agreed upon by the plaintiff and his attorney, can be collected only if the plaintiff prevails at trial. The defendant's attorneys' fees will total $5000. If the plaintiff succeeds at trial, he must pay attorneys' fees in the amount of $33,333. If the plaintiff loses at trial, he will pay no attorneys' fees. The plaintiff believes that if he prevails at trial he will be awarded $100,000. On the advice of counsel, the plaintiff believes that he has a 3% chance of prevailing at trial. The plaintiff then decides to file suit since his expected judgment from a trial would be $3000, which would exceed his legal costs of $0 if the plaintiff loses.[176] If the plaintiff succeeds at trial, he achieves a windfall of $64,667. In this situation, the plaintiff will file suit since his expected judgment of $3000 exceeds his personal legal costs of $0 if he loses.[177]

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precaution." COOTER & ULEN, *supra* note 84, at 322.) This is so because under the American Rule, potential tortfeasors are not discouraged from acting in an unsafe or tortious manner where the potential for substantial damages is low. Both of the above propositions by Shavell and Katz are seemingly true and logical conclusions but fail to take into account the "fee shifting personal responsibility model," which is developed below and predicts that under a fee shifting tort scheme potential plaintiffs will take responsible actions ex ante in the form of purchasing insurance to cover their potential pecuniary damages.

[173] *See* Shavell, *supra* note 160, at 58-60.

[174] *See* EPSTEIN, *supra* note 22, at 904; Kritzer, *supra* note 22, at 1976 ("contingency fees can create incentives to take cases that a lawyer would not otherwise take or that a litigant would not otherwise bring").

[175] *See* EPSTEIN, *supra* note 22, at 897-902 (Epstein describes the allowance of a contingency fee arrangement as the most dominant feature of the American legal system.).

[176] There is a possibility, however, that the plaintiff's attorney chooses not to represent the plaintiff in a case where the attorney's legal costs exceeds the expected judgment. Although the attorney may be able to take a substantial amount of such risky claims since he likely has a large portfolio of claims.

[177] In this case, even if the plaintiff is required to pay the legal costs, excluding attorneys' fees, regardless of whether the plaintiff is successful, the plaintiff still chooses to file suit since his expected judgment ($3000) exceeds his certain legal costs ($2000). "The American [R]ule, [simply] provides no deterrent to groundless litigation." Feuerstein, *supra* note 33, at 128.

The English Rule would offset the risk-free element, even in a contingency fee arena, which allows tort plaintiffs to prosecute a claim with little or no merit (**Example D-2**). Using the same facts as in Example D-1 above, the English Rule plaintiff would not file the same suit, which has only a 3% chance of victory. The plaintiffs expected judgment from a trial of $3,000 does not exceed his expected legal costs of $4,850.[178] Thus, the English Rule plaintiff does not file such a weak suit as the American Rule plaintiff does. As shown by this example, the English Rule dissuades a potential plaintiff from filing a weak suit. Otherwise, if that plaintiff were to pursue such a weak suit and lose, the plaintiff would bear the defendant's legal costs.

2. How About the Risk Averse?

Some scholars argue that the English Rule inhibits the ability of parties lacking substantial resources or the risk-averse to have access to the courts.[179] It is obviously true that the English Rule magnifies the plaintiff's risk. As discussed above, however, the author argues that a rational plaintiff will file suit under the English Rule if his judgment exceeds his legal costs—even the risk-averse plaintiff. As the probability of success approaches certainty, the possibility of paying the defendant's attorneys' fees should not affect the plaintiff's decision to file suit.[180] Moreover, because a lawsuit can be divided up in several separate units or procedural stages, the ostensible dissuasion of risk-averse parties to file suit is offset by the mechanics

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[178] Using formula $P_w \times A > P_L \times (C_p + C_D)$, we can clearly see that the plaintiff's expected judgment of $3000 (*3% x $100,000*) does not exceed the plaintiff's expected legal costs of $4850 (*97% x (0 + $5000)*). (Note: $C_p$ is zero in our formulation because those costs are born by the plaintiff's attorney.)

[179] *See* John F. Vargo, *The American Rule on Attorney Fee Allocation: The Injured Person's Access to Justice*, 42 AM. U. L. REV. 1567 (1993) ("[T]he English Rule operates as a greater impediment to access to justice than does the American Rule."); Jonathan T. Molot, *How U.S. Procedure Skews Tort Law Incentives*, 73 IND. L.J. 59 (Winter 1997) ("While risk aversion may lead plaintiffs to forego meritorious lawsuits even under an American [R]ule, the English fee-shifting rule aggravates this problem. By guaranteeing the prevailing plaintiff a higher recovery, and the losing plaintiff a greater loss, the English fee-shifting rule increases the stakes of litigation. The fear of paying their opponents legal fees, in addition to their own, may lead to risk-averse plaintiffs to forego suits they would otherwise file under the American system."); Herbert M. Kritzer, *The English Rule*, 78 A.B.A. J. 55, at 55 (Nov. 1992) ("It is generally accepted that the English Rule discourages privately funded parties from bringing meritorious claims.").

[180] *See* Thomas D. Rowe, Jr., *Predicting the Effects of Attorney Fee Shifting*, 47 LAW & CONTEMP. PROBS., at 139, 149 (Winter 1984).

of the legal system.

There are several separate units or procedural stages to consider in the United States system.[181] The first unit is the filing of a complaint. The second unit is the motion stage, where motions such as for summary judgment are considered. The third unit is the exchange of information. This unit encompasses general negotiating and discovery. The fourth unit is the decisional unit. This unit is the period of time wherein the plaintiff decides to try to settle the case or proceed to trial. The fifth unit is the trial. The sixth unit is the appellate process. At any point between or during any of the six units the plaintiff can decide to drop the suit without penalty.

A plaintiff's decision to continue with the suit clearly depends on the progression of the suit. Thus, the plaintiff looks at each stage in the suit as an option to purchase, including actually filing the complaint.[182] From the plaintiff's viewpoint, each purchase of an option increases the value of the plaintiff's case and makes the plaintiff less risk-averse. Figure 1 demonstrates how the purchase of each option increases the value of the case to the plaintiff and increases the probability of the plaintiff achieving his expected judgment.[183]

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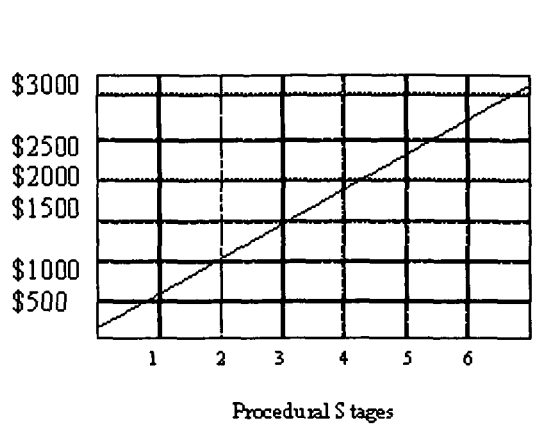
[181] For simplicity sake, in analyzing the separate units or procedural stages of a tort suit, this article will examine the United States system. There are many differences in the mechanics of a civil legal system throughout the world. COOTER & ULEN, *supra* note 84, at 395. For example, in Germany and most civil law countries, discovery does not occur before the beginning of a trial but rather as a first phase of a trial. *Id.* This is called the "giving of proofs. *Id.* Notwithstanding the differences in procedure, the general point remains constant; that is, there are separate units or procedural stages within a particular lawsuit.

[182] *See* Katz, *supra* note 30, at 67, 72. "[M]ost lawsuits are divided into a series of procedural stages, at each of which it is possible to decide whether to continue depending on how the case is going." *Id.* at 72. "Plaintiffs, accordingly, will choose to spend legal resources up to the point where their expected recoveries, net of expenses, are maximized; defendants will act so as to minimize total payouts." *Id.* at 67; *see also* Bradford Cornell, *The Incentive to Sue: An Option Pricing Approach,* 19 J. LEG. STUD. 173-87 (1990).

[183] *See* Katz, *supra* note 30, at 67 (arguing that based on the economic theory of litigation developed by Landes, *supra* note 159, Posner, *supra* note 159, and Gould, *supra* note 159, amounts spent on trial preparation can be seen as a type of private investment).

**Figure 1**




Professor Katz sums up this point:

> Just as financial options can sell for a positive price even if the probability of exercising them is low, the option value of litigation can make it profitable to put forward claims with negative expected value. Because the value of an option increases with its variance, the English [R]ule, by increasing both the upside and the downside of litigation, intensifies this incentive. Indeed, if parties can drop arguments before trial without penalty, such enhanced option value could increase litigation even by the risk-averse.[184]

This line of thinking is consistent with the tendency of risk-averse plaintiffs to settle their claims before proceeding to trial.[185] Moving towards a fee-shifting scheme would not alter that tendency. Therefore, the argument that the risk-averse plaintiff might be unjustly discouraged from instituting a tort claim to vindicate his rights if the penalty for losing included the fees of their opponents' counsel appears to be theoretically unfounded.[186] In addition, any deterrent effect on risk-averse plaintiffs for filing a claim under the

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[184] Katz, *supra* note 30, at 72.

[185] *See* SHAVELL, *supra* note 32, at 406.

[186] Furthermore, the argument that the risk-averse plaintiff might be unjustly discouraged from instituting a tort claim under the English Rule appears to be empirically unfounded. Germany, Sweden, Israel, and Austria, all of which abide by the English Rule, have much higher litigation rates than the United States, which is governed by the American Rule. *See* Kritzer, *supra* note 22, at 1982 (Litigation rates are listed as follows: Germany, 123.2; Sweden, 111.2; Israel, 96.8; Austria, 95.9.).

English Rule would be substantially decreased under a contingency fee arrangement.[187] This is so because the plaintiff is able to shift some of the increased risk to his own attorney.[188]

As discussed above, a plaintiff under the English Rule will file suit in a particular case if his expected judgment is at least as large as his legal costs. This theory does not change for a risk-averse plaintiff; such a plaintiff may be only more prone to settle his claim. If one were to assume that the risk-averse plaintiff is ambivalent about filing suit even if his expected judgment outweighs his expected legal costs, then this would be offset by the ability to purchase an option in litigation. Moreover, if a plaintiff is truly risk-averse, then he will purchase insurance to comprehensively cover any risk that he bears,[189] making filing a suit a futile luxury and not a necessity to make one whole except for the recovery of non-pecuniary damages as discussed below.

### 3. Encouraging Weak Cases: An American Rule Problem

The final conclusion that can be reached from the above theoretical economic analysis is that American Rule plaintiffs are more likely to file frivolous suits and suits with a low probability of victory than English Rule plaintiffs. The English Rule discourages the filing of weak or frivolous suits and encourages a more effective and efficient tort scheme.[190] The English Rule essentially works like a "Pigou tax" or "corrective tax" so that a plaintiff internalizes potential costs in his initial decision-making. Economist Arthur Pigou observed that if the government is going to raise revenue why not

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[187] Katz, *supra* note 30, at 88, 89.

[188] If the English Rule were implemented for tort cases in the United States, it is highly likely that attorneys would be willing to take on the risk of the defendant's attorneys' fees as well. *See* Mark S. Stein, *The English Rule with Client to Lawyer Risk Shifting: A Speculative Appraisal*, 71 CHI.-KENT L. REV. 603, 611 (1995). In this case, "[i]f the case were lost, the defendant's fees would be paid not by the plaintiff, but by the plaintiff's law firm, which presumably could better bear the burden. Moreover, with the risk of ruin removed . . . plaintiffs would not be deterred by their risk aversion from bring [*sic*] and pursuing meritorious claims." *Id.* With that being said, as alluded to *infra*, in an English Rule scheme it is not economically practical to require the losing party to pay the winning party's fees and not have that amount included as part of the risk born by the plaintiff's attorney.

[189] SHAVELL, *supra* note 32, at 261.

[190] *See* Robert G. Bone, *Agreeing to Fair Process: The Problem with Contractarian Theories of Procedural Fairness*, 83 B.U. L. REV. 485, 537 (June 2003).

attach a tax to "bads" rather than "goods."[191] The purpose of a corrective tax, Pigou argued, is to correct the bias of using too much of an apparently free resource.[192] Pigou's point was that there should be taxes on noise, smoke, and similar nuisances because such a tax ultimately improves welfare.[193] The English Rule imposes a type of "corrective tax" on losing cases requiring the reimbursement of the winning party's attorneys' fees, thereby discouraging tort plaintiffs with a low probability of success from filing suit and wasting resources in the process.[194] Thus, the English Rule improves the social welfare and even provides a sense of "corrective justice" by promoting claims that are fairly meritorious when viewed from an ex ante perspective.[195]

### B. *Decisions to Settle Rather than Proceed to Trial*

There is a vast amount of theoretical economic literature on the effects of fee-shifting rules on decisions to settle rather than proceed to trial.[196] Perhaps this is so because most tort cases are

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[191] ARTHUR PIGOU, PUBLIC FINANCE (Macmillan 1928).

[192] *Id.*

[193] *Id.*

[194] The English Rule does not impose a real tax on an externality. Comparing the English Rule to the Pigou tax is merely an analogy. It does not suffer the pitfalls of a *real* tax on externalities as proved by economist Ronald Coase. Pigou's view of externalities was widely accepted by economists until Ronald Coase persuaded economic scholars that Pigou's analysis of externalities was wrong for three reasons: (1) existence of externalities does not necessarily lead to an inefficient result; (2) Pigouvian taxes do not in general lead to the efficient result; and (3) the problem is not externalities, it is transaction costs. *See* FRIEDMAN, *supra* note 70, at 39. Coase's belief was that "all rights move to those to whom they are of greatest value, giving us an efficient outcome." *Id.* at 39. Coase's Theorem can be summarized this way: "If transaction costs are zero, if, in other words, any agreement that is in the mutual benefit of the parties concerned gets made, then any initial definition of property rights leads to an efficient outcome." *Id.* at 39. The fee shifting scheme can also be analyzed under the Coase theorem. Using the Coase Theorem, one can argue that fee shifting achieves the most efficient result by allocating all of the rights to be free from attorneys' fees to the winning party.

[195] *See* Katz, *supra* note 30, at 71.

[196] William Landes and John Gould advocate that optimistic parties are more likely to proceed to trial rather than settle the case; similarly, non-optimistic parties are more likely to settle. Landes, *supra* note 159, at 61-101; Gould, *supra* note 159, at 279-300. Judge Richard Posner and Professor Steven Shavell developed a model of the litigation decision to settle or try a case that suggested that the English Rule would reduce the likelihood of settlement. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 537-40 (3d ed. 1986); Shavell, *supra* note 160, at 65. John Donohue argues, however, that Posner and Shavell reached this conclusion because they neglected to consider the Coase Theorem outlined by Ronald Coase thirty years ago in his

ground-breaking article, Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). See *supra* note 194 for an explanation of the Coase Theorem. For further discussion, see generally 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 (1991). Keith Hylton, however, dismissed Donohue's theory:

> John Donohue has recently argued that the Coase theorem implies that settlement frequencies should be the same under the British and American rules. The reason is that if the plaintiff is relatively optimistic, both parties, under certain conditions, will be made better off ex ante by agreeing to comply with the British rule. Given that the parties will have an incentive to adopt the cost allocation rule that maximizes joint wealth, one should observe the same settlement rates under the American and British rules. The rules simply are default provisions around which the parties are free to bargain.
>
> The Coase theorem identifies some important theoretical issues in the examination of settlement incentives. [However, the Coase Theorem] . . . is unlikely to explain settlement patterns. . . . No empirical support for the theory as an explanation of settlement patterns exists. More importantly, the theory suffers from an important flaw: it applies an argument originally established under different liability rules to an inappropriate setting. To be more specific, the Coase theorem demonstrates that in a regime of frictionless bargaining the parties will adopt the cost-minimizing set of precautions, regardless of the liability rule in effect. In other words, if the rule in effect is strict liability, the parties may negotiate a waiver of liability if such an arrangement is wealth maximizing, with appropriate side payments exchanged.
>
> In the litigation problem Donohue analyzed, the parties attempting to settle their case are doing something analogous to negotiating a waiver of liability. The notion that they might contractually arrange for a different fee shifting rule would require the parties to suspend settlement negotiations in order to negotiate over a fee shifting rule that maximizes wealth, in the event that they choose to litigate. How likely is this to occur? Would not the offeree doubt the sincerity of the offeror's professed desire to settle the dispute if the offeror proposes adopting a new fee shifting rule if settlement negotiations fail? Would not such an offer be taken as a signal of a desire to litigate under the proposed fee shifting rule?

Hylton, *supra* note 161, at 1079, 1080. Using a Bayesian (named after Reverend Thomas Bayes, 1702-1761) model of settlement, as opposed to the "Optimism Model," Cooter, Marks and Mnookin argue that trials are not caused by optimism but by uncertainty over the opponent reservation settlement value. Robert D. Cooter, Stehern Marks & Robert Mnookin, *Bargaining in the Shadow of the Law*, 11 J. LEGAL STUD. 225 (1982). Bayesian models of settlement suggest that the English Rule discourages settlement in disputes revolving around liability. *See* Lucian A. Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. OF ECON. 404 (1984); Jennifer F. Reinganum and Louis L. Wilde, *Settlement, Litigation and the Allocation of Litigation Costs*, 17 RAND J. OF ECON. 557 (1986); Eric Talley, *Liability-Based Fee-Shifting Rules and Settlement Mechanisms Under Incomplete Information*, 71 CHI.-KENT L. REV. 461 (1996). For a discussion on the Bayesian models, see Katz, *supra* note 30, at 74-75. Other important contributions to the settlement issue as it relates to fee shifting include: Bradley L. Smith, *Three Attorney Fee-Shifting Rules and Contingency Fees: Their Impact on Settlement Incentives*, 90 MICH. L. REV. 2154, 2155 (1992); John C. Hause,

settled rather than tried.[197] The question that most economic legal scholars ask is what effect the English Rule has on the settlement of suits. The most important question in the settlement context, however, is what effect the English Rule has on overall litigation. This was addressed in part above. To focus on the importance of settlement alone without the examination of the effect on the overall amount of litigation is short-sighted and illogical from the standpoint of determining which rule, the American or English, is more economically sound. This section will examine both questions briefly.

1. Non-Contingency Fee Scheme

As discussed in the preceding section, under the English Rule, plaintiffs are more likely to file suits with a greater likelihood of success than plaintiffs under the American Rule. Thus, it logically flows that plaintiffs under the English Rule are generally more optimistic when filing suit. Therefore, using this optimism logic, under a non-contingency fee scheme, English Rule plaintiffs, as a whole, are less likely to settle cases than American Rule plaintiffs.[198] The English Rule effectively reduces the sum of the expected legal costs[199] and effectively raises the expected judgment.[200]

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*Indemnity, Settlement, and Litigation, or I'll Be Suing You*, 18 J. LEGAL STUD. 157, 167-68 (1989) (argues that switching from the American Rule to the English Rule would likely lead to more settlements, mostly because tried cases would cost more); Avery Wiener Katz, *Measuring the Demand for Litigation: Is the English Rule Really Cheaper?*, 3 J.L. ECON & ORG. 143 (1987); Geoffrey P. Miller, *An Economic Analysis of Rule 68*, 15 J. LEGAL STUD. 93, 122-23 (1986); Posner, *supra* note 159, at 428-29.

[197] For example, according to the Congressional Budget Office, "in the vast majority of cases, plaintiffs and defendants reach out-of-court settlements, whose terms typically remain private. For example, 97% of tort cases that 'terminated' in federal district courts in fiscal year 2000 were disposed of before a verdict was reached." CONGRESSIONAL BUDGET OFFICE, THE ECONOMICS OF U.S. TORT LIABILITY: A PRIMER viii (2003), *available at* http://www.cbo.gov/ftpdocs/46xx/doc4641/10-22-TortReform-Study.pdf.

[198] This is so because continuing with the suit is more attractive to the English Rule plaintiff. *See* Hylton, *supra* note 161, at 1079; *See* Smith, *supra* note 196, at 2176 ("a facial examination of the settlement conditions indicates more settlements under the American [R]ule"). This article will not examine whether a shift to the English Rule would increase total expenditures on litigation. However, for a discussion on such matters *see* Ronald R. Braeutigam, Bruce M. Owen, and John C. Panzar, *An Economic Analysis of Alternative Fee-Shifting Systems*, 47 LAW & CONTEMP. PROBS. 173-185 (Winter 1984); Katz, *supra* note 30, at 67-68 (both articles argue that total litigation expenditures increase under the English Rule). *But see* Rowe, *supra* note 180, at 159.

[199] The "Optimism Model" ("Landes-Gould Model"), developed by John Gould and William Landes, suggests that fee shifting magnifies plaintiffs' optimism, making them less likely to settle and dissuades the non-optimistic parties from settling.

Settlement normally occurs when the plaintiff's minimum demand is less than the defendant's maximum settlement offer.[201] Under the American Rule, a plaintiff's minimum settlement demand is represented as: $P_{pw}A - C_P$; the defendant's maximum offer is $P_{dw}A + C_D$.[202] The variables denote the following: $P_{pw}$ represents the plaintiff's estimate of the probability of the plaintiff prevailing at trial; $P_{dw}$ represents the defendant's estimate of the probability of the plaintiff prevailing at trial; $A$ represents the prevailing award amount; $C_P$ represents the plaintiff's legal costs of the litigation; and $C_D$ represents legal costs of the litigation. The "settlement zone" is the difference between the maximum offer and the minimum demand.[203] Settlement will occur under the American Rule if: $(P_{pw}-P_{dw})A < (C_P+ C_D)$.[204]

Consider the following example under the American Rule:

> **(Example E).** In a general negligence claim, the plaintiff believes that he has an 80% chance ($P_{pw}$) of prevailing at trial in the amount of $100,000 ($A$); whereas, the defendant believes that the plaintiff has a 58% chance ($P_{dw}$) of prevailing at trial in the amount of $100,000 ($A$). The plaintiff's legal costs would be $10,000 ($C_p$), and the defendant's legal costs would be $15,000 ($C_d$). Therefore, the plaintiff's minimum settlement demand is $70,000,[205] and the defendant's maximum offer is $73,000.[206] Settlement occurs here between the range of $70,000 and $73,000 because the perceived difference in the stakes is less than the total cost of litigation.[207]

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Landes, *supra* note 159, at 61-101; Gould, *supra* note 159, at 279-300; *see also* Katz, *supra* note 30, at 73; Smith, *supra* note 196, at 2155; Hylton, *supra* note 161, at 1079.

[200] *See* Hylton, *supra* note 161, at 1079.

[201] Shavell, *supra* note 160, at 63-66; Hylton, *supra* note 161, at 1078.

[202] Shavell, *supra* note 160, at 64; Hylton, *supra* note 161, at 1078.

[203] *See* Linda R. Stanley & Don L. Coursey, *Empirical Evidence on the Selection Hypothesis and the Decision to Litigate or Settle*, 19 J. LEGAL STUD. 145, 147 (1990); Hylton, *supra* note 161, at 1079.

[204] Hylton, *supra* note 161, at 1078 ("[S]ettlement occurs if the perceived difference in the stakes is less than the total cost of litigation."); *see also* Shavell, *supra* note 160, at 63.

[205] *0.8($100,000) - $10,000 = $70,000.*

[206] *0.58($100,000) + $15,000 = $73,000.*

[207] *(0.8 - 0.58)$100,000 < ($10,000 + $15,000) = $22,000 < $25,000.* *See* Shavell, *supra* note 160, at 63-64; Hylton, *supra* note 161, at 1078.

Under the English Rule, the plaintiff's minimum settlement demand is $(P_{pw}A - (1-P_{pw})(C_P + C_D)$, and the defendant's maximum settlement offer is $P_{dw}A + P_{dw}(C_P + C_D)$. Settlement will occur if $(P_{pw}-P_{dw})A < (1-P_{pw} + P_{dw})(C_p + C_d)$.[208] Consider the following example under the English Rule:

> **(Example F).** In the same general negligence claim above, the plaintiff's minimum settlement demand is $75,000[209] and the defendant's maximum offer is $72,500.[210] Settlement does not occur here.[211]

On the other hand, an English Rule plaintiff who may have a good case but for some reason does not feel quite optimistic about his case or feels that his chance of winning at trial is a close call, but his expected judgment is at least as large as his and the defendant's legal costs, is more likely settle since the plaintiff risks paying the defendant's litigation costs if the plaintiff loses.[212]

2. Contingency Fee Scheme

The settlement probabilities change under a contingency fee arrangement. When a contingency fee attorney represents the plaintiff and the plaintiff is responsible to pay the defendant's attorneys' fees in the event of a loss, settlement is more likely to occur under the English Rule.[213] Consider the following analysis under a typical contingency fee arrangement:

> **(Example G).** The facts in this scenario are the same as **Examples E** and **F**, except this example assumes that the plaintiff believes that he has a 75% chance of prevailing at trial ($P_{pw}$) instead of 80%. Under the American Rule, the plaintiff's minimum

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[208] *See* Shavell, *supra* note 160, at 64.

[209] *(0.8($100,000) - (1 - 0.8)($10,000 + $15,000) = $75,000.*

[210] *(0.58($100,000) + 0.58($10,000 + $15,000) = $72,500.*

[211] *(0.8 - 0.58)$100,000 < (1 - 0.8 + 0.58) ($10,000 + $15,000) = $22,000 < -$9500.* Since $22,000 is not less than -$9500 settlement will not occur here.

[212] *See* Katz, *supra* note 30, at 74.

[213] *See* Smith, *supra* note 196, at 2175-2180. Contingent fee arrangements can work under the English Rule. *See* Rowe, supra note 22, at 674 ("[N]othing about fee shifting makes contingent fee arrangements impossible."). In fact, many European jurisdictions have rules concerning the determination of attorney fees that produce results that are similar to those of a contingent fee arrangement. *See* Pfennigstorf, *supra* note 25, at 60-61.

> settlement demand is $75,000.[214] This is so because the plaintiff does not take his legal costs into account. The defendant's maximum offer is the same as before, $73,000.[215] Thus, here, there is no settlement under the American Rule.[216] On the other hand, under the English Rule, the plaintiff's minimum settlement demand is $71,250.[217] In formulating this amount, one should take into account only the defendant's legal costs. The defendant's maximum offer is the same as before, $72,500. Here, unlike under the American Rule, there is room for settlement under a contingency fee arrangement.[218]

The above analysis demonstrates that the addition of the contingency fee element can cause a complete turnaround in the plaintiff's decision to settle a claim.[219] This is quite significant in light of the fact that contingency fee arrangements are typical in a tort claim in the United States. Thus, Steven Shavell's and Richard Posner's concern that having the United States switch to the English Rule would lead to the counterintuitive result of lower settlement rates is overstated, at least in the tort context where contingency fee arrangements reign as the most prevalent fee arrangement.[220]

3. Reducing Tort Filings

Settling a suit is usually much more efficient than proceeding to trial. Thus, determining which rule, the American or the English, promotes settlement is quite important. However, it is also important to not lose sight of the overall goal, preventing future tortious conduct and the filing of a suit altogether, which by far produces the most efficient result. Unfortunately, most scholars seem to skip this point and simply discuss which rule promotes settlement. Assuming arguendo, that English Rule plaintiffs are less likely to settle suits than American Rule plaintiffs, the English Rule tends to encourage

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[214] *0.75($100,000) - $0 = $75,000.*

[215] *0.58($100,000) + $15,000 = $73,000.*

[216] *(0.75 - 0.58)$100,000 < ($15,000) = $17,000 < $15,000.* Since $22,000 is not less than $15,000 settlement will not occur in this case.

[217] *(0.75($100,000) – (1 - 0.75) ($0 + $15,000) = $71,250.*

[218] *(0.75 - 0.58)$100,000 < (1 - 0.75 + 0.58)($10,000 + $15,000) = $17,000 < -$8250.* Since $17,000 is not less than -$8250 settlement will not occur here.

[219] *See* Smith, *supra* note 196, at 2180 ("[W]hen the plaintiff's attorney is retained on a contingency basis, the plaintiff will more often favor settlement under the British rule than the American rule . . . .").

[220] Richard A. Posner, *Comment on Donohue*, 22 LAW & SOC'Y REV. 927, 928 (1988); Shavell, *supra* note 162, at 65.

good behavior, thus curtailing the need for litigation.

Under the optimism model, the better the case, it is less likely that the English Rule plaintiff will settle. The English Rule plaintiff will tend to vigorously pursue cases to the end of trial where the probability of a plaintiff victory is high since the plaintiff can also win his attorneys' fees. Settlement will occur more in close cases, where the plaintiff's and defendant's probabilities of victory are reasonably close. As a result of such a scenario under the English Rule, potential tortfeasors will take greater care. Consequently, future behavior will improve, and the overall volume of litigation will decrease.[221]

First, potential tortfeasors know that failure to take the optimal amount of care could result in a suit against them, even a case with small stakes as discussed above. Second, the expected liability is higher, which results in a further decrease in the probability of settlement where the plaintiff is fairly optimistic about winning at trial. Simply put, potential tortfeasors have incentives to take care, knowing that their potential liability may not be reduced by a settlement amount and that they face the increased liability of attorneys' fees, substantially increasing the penalty for their conduct.[222] Thus, it is better for potential tortfeasors to behave optimally than to proceed through litigation where they risk paying a hefty price for their tortious conduct. Logically, the less tortious conduct that occurs, the fewer tort suits that are filed. Moreover, implementation of the English Rule encourages this result by decreasing the filings of low probability suits. Third, because the increase in potential liability generates greater compliance, the overall incentives to bring suit are diminished.[223] Potential plaintiffs will be less likely to file suit because they know that if compliance with the law increases then the probability of victory is small, effectively closing the gap on high probability cases.[224] In sum, the English Rule

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[221] Steven Shavell concluded that the overall volume of litigation resulting from automobile accidents would be reduced under the English Rule. Shavell, *supra* note 160, at 55, 69-70. For a discussion of fee shifting effects on the overall volume of litigation, see Katz, *supra* note 196, at 143; Richard L. Schmalbeck & Gary Myers, *A Policy Analysis of Fee-Shifting Rules Under the Internal Revenue Code*, 1986 DUKE L.J. 970, 975-76 (1986); Alfred F. Conard, *Winnowing Derivative Suits Through Attorneys' Fees*, LAW & CONTEMP. PROBS., 269 (Winter 1984).

[222] *See* Keith N. Hylton, *Fee Shifting and Predictability of Law*, 71 CHI.-KENT L. REV. 427, 442 (1995) ("Because the increase in liability is greater under the British [(English)] rule, one should observe greater compliance under it than under the American rule.").

[223] *See id.*

[224] *See id.*

promotes efficiency by encouraging the optimal amount of care and discouraging the filing of suits with less than a high probability of success.

### C. *The Development of the Law and the Diminishing Acceptance of Personal Responsibility*

As demonstrated above, the American Rule encourages plaintiffs with a low probability of victory to file suit. Therefore, it is no surprise that risky, innovative tort claims are more likely to be brought under the American Rule, and contingency fee arrangements compound this scenario.fn 225 The plaintiff does not bear the risks of failure under a contingency fee arrangement in an American Rule scheme; the plaintiff's attorney and the defendants bear such risks. fn225 Thus, such risky claims are initiated predominantly in the United States. fn226 These types of claims typically are unsuccessful and result in an enormous amount of wasted resources; however, even if such claims are successful they still usually lead to an inefficient result. Moreover, the American Rule tends to promote the concept of blame and not taking personal responsibility for one's own actions, a seemingly solely moral problem fraught with efficiency consequences.

#### 1. The Case of McDonald's

The American Rule's promotion of risky claims and the resulting inefficiencies caused by such filings can be best demonstrated by the recent lawsuits filed against "Big Food"[227] chains, such as McDonald's, for allegedly causing obesity in its consumers.[228]

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[225] *See id.*

[226] *See id.* If such risky claims somehow succeed, they are likely to be replicated in other countries. *Id.* at 905; *see also* J. Robert S. Prichard, *A Systematic Approach to Comparative Law: The Effect of Cost, Fee, and Financing Rules on the Development of the Substantive Law*, 17 J. LEGAL STUD. 451 (1988). For a general discussion of the development of the law in the fee-shifting context, see Robert S. Prichard & Andrea Saltzman, *Incorporating Statutes into the Common Law: The Judicial Response to Statutes Shifting Attorneys' Fees*, 30 ST. LOUIS U. L.J. 1103 (1986). The American Rule simply breeds risky suits—suits that would not be filed under the English Rule because they bear such risk. *See* Examples D-1 and D-2 *supra* pp. 34-35.

[227] James Justin Wilson, *Battling the Fat Suits*, NAT'L REV. ONLINE (July 21, 2003), www.nationalreview.com/nr_comment/nr_comment072103.asp.

[228] Tobacco products liability suits also serve as a great example of the erosion of the personal responsibility doctrine (a.k.a. "assumption of the risk") under the American Rule. *See* Richard L. Cupp, Jr., *A Morality Play's Third Act: Revisiting*

As discussed above, American Rule plaintiffs are not discouraged from filing such seemingly outrageous suits. Under the American Rule, plaintiffs unabashedly file suits blaming someone else for a choice that they themselves have made: eating a lot of non-nutritious food.

Are we to assume that plaintiffs are not responsible for the well-informed choices that they decided to make? It was the plaintiff's choice to buy the Big Mac. McDonald's did not force the plaintiff to buy it. It was the plaintiff's choice to overindulge. McDonald's did not force the plaintiff to eat the burger and fries. Consumers are responsible for what they eat.[229] Yet, that does not stop an American Rule plaintiff who risks nothing by enlisting the help of an attorney willing to take the case on a contingency fee basis and filing suit against a big-pocket "Big Food" chain.[230] As writer Andrew Stuttaford points out, "as we saw in the cigarette wars, notions of personal responsibility are either watered down . . . or denied altogether" [231] under the American Rule. Under the American Rule, there is no deterrent for a plaintiff to file such a suit. It would not likely be considered a frivolous suit under Federal Rule of Civil Procedure 11 or similar state rules.[232] A creative attorney can come up with some seemingly legitimate claim.

Not surprisingly suits against McDonald's have failed.[233] In one decision, U.S. District Court Judge Robert Sweet correctly noted:

> If a person knows or should know that eating copious orders of super-sized McDonald's products is unhealthy and may result in weight gain (and its concomitant problems) because of the high levels of cholesterol, fat, salt and sugar, it is not the place of the law to protect them from their own excesses. Nobody is forced to

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*Addiction, Fraud and Consumer Choice in "Third Wave" Tobacco Litigtion*, 46 U. KAN. L. REV. 465 (1998) (contrasting the 1990's, when tobacco companies generally won suits filed against them, to present times, when persons filing suit against tobacco companies have been increasingly successful).

[229] Andrew Stuttaford, *Iced Vice, Screaming about Ice Cream*, NAT'L REV. ONLINE (Aug. 28, 2003), www.nationalreview.com/stuttaford/stuttaford082803.asp.

[230] Contingency fee attorneys do not shy away from the big risky cases against big-pocket corporations, knowing that the payoff could be great. *See* James H. Stock & David A. Wise, *Market Compensatin in Class Action Suits: A Summary of Basic Ideas and Results*, 16 CLASS ACTION REP. 584, 601 (1993) ("[Law] firms will bear risk if they are compensated for the risk; [m]ore risk requires greater compensation."); *see also* Kritzer, *supra* note 22, at 1974-78.

[231] Stuttaford, *supra* note 229.

[232] FED. R. CIV. P. 11.

[233] *Judge Throws Out Refiled Obesity Suit Against McDonald's*, FOX NEWS, Sept. 4, 2003, *available at* http://www.foxnews.com/story/0,2933,96452,00.html.

> eat at McDonald's. Even more pertinent, nobody is forced to super-size their meal or choose less healthy options on the menu.[234]

The American Rule simply promotes the annihilation of the notion of personal responsibility, where individuals are responsible for their own actions. Writer Doug Bandow describes the diminishing acceptance of personal responsibility and the status of the tort system under the American Rule:

> Responsibility used to be the hallmark of American freedom. Act as you wish, but accept the consequences: Smoke, get cancer. Eat, get fat. Fall down drunk, get hurt. Just don't act surprised—and certainly don't blame anyone else.
>
> No longer. Today the hallmark of American freedom is litigation. Act as you wish, but make sure someone else suffers the consequences. Indeed, America's liability system has become the international standard of what not to do.[235]

The American Rule encourages plaintiffs to engage in risky behavior,[236] such as eating poorly and smoking, and to concoct risky claims as a way of landing a windfall to compensate for their well-informed poor choices, all at the expense of efficiency. The defendants in such cases as described above have to defend these suits and invest thousands of dollars in legal fees—an expense the plaintiffs see as no cost. Society ultimately bears the burden of the mounting legal costs caused by such filings, regardless of whether they are ultimately successful or not.[237] As a result of such lawsuits it

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[234] Wilson, *supra* note 227.

> How does one prevent companies from producing food that when eaten in abundance leads to obesity? Stop eating their food! One must not forget the effectiveness of consumer power. As the number of individuals who participate in the low carbohydrates diet grows so do the stores and restaurants that oblige the wants and desires of the consumers by carrying such "carb-friendly" foods.

[235] Doug Bandow, *Shyster Heaven*, NAT'L REV. ONLINE (April 21, 2003), www.manhattan-institute.org/html/_national_review-shyster_heave.htm.

[236] An individual is more likely to engage in risky behavior if he knows that at some point he can be compensated for his risky behavior.

[237] United States Representative John Carter expressed awareness of this societal burden in an April 1, 2004 press release: "Employers like McDonald's constantly worry about frivolous lawsuits by customers who claim to have gained weight eating too many of their cheeseburgers. Maintaining legal counsel and paying to fight such petty lawsuits keep employers from hiring more employees." Press Release, U.S. Rep.

can be expected that McDonald's, for example, will eventually slim down its menu, which it has already started; eliminate tasty ingredients, which are completely acceptable and appropriate in moderation; hire nutritional advisory councils, which can be very expensive; and work against their own profits and raise prices in order to continue to make a profit.[238]

News of such obesity suits in the United States has already caused economic ramifications both nationally and internationally. In March 2004, McDonald's announced that it was eliminating its highly lucrative Super Size french fry and soft drink option.[239] This announcement did not come from a lack of consumer demand—one in ten customers requested the upgrade.[240] Rather, "[i]t died from well, supersized interest."[241] McDonald's "was being targeted [by advocacy groups and lawyers] as the fast-food world's near equivalent of nicotine."[242] Even McDonald's France took out a paid advertisement in a magazine urging its customers not to visit its restaurants more than once a week.[243]

Fear of litigation, due to of the ease and risk-free nature of filing a tort claim under the American Rule, is crippling to the American and international economies and stifles the freedom of the American citizenry.[244] Commenting on the state of America, American writers Stuart Taylor Jr. and Evan Thomas declare:

> Our society has been changed in a subtler, sadder way. We have been hardened and made more fearful. . . . Perversely, our insistence on enforcing our "rights" has made us less free—less free to use our own judgment to make common sense or humane choices about the way we live and treat others.[245]

A typical example of the cost that society now bears because of legal fear is the removal of playground equipment throughout the

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John Carter, Tax Cuts & Jobs Go Hand-in-Hand, Apr.1, 2004, *available at* http://www.house.gov/pence/rsc/doc/Carter-tax%20cuts.doc.

[238] *See* Stuttaford, *supra* note 229.

[239] Bruce Horovitz, *By Year's End, Regular Size Will Have To Do*, USA TODAY, Mar. 4, 2004, at 3B.

[240] *Id.*

[241] *Id.*

[242] *Id.*

[243] Andrew Stuttaford, *Mac Attacked*, NAT'L REV. ONLINE (July 7, 2003), www.nationalreview.com/stuttaford/stuttaford070703.asp.

[244] *See* Taylor & Thomas, *supra* note 11, at 45-46.

[245] *Id.*

United States due to the thousands of suits by individuals who have injured themselves.[246] Playground equipment such as monkey bars, jungle gyms, and seesaws improved the physical fitness of the American youth.[247] Now, American children sit on the couch, play Sony's PlayStation 2, eat McDonald's food, and get fat, resulting in the children's parents suing McDonalds.[248] What we have now is a sad irony perpetuating laziness and swallowing the notion of personal responsibility.

Under the English Rule, the plaintiffs would not dare to prosecute such an obesity claim, as evidenced by **Example D2** above, lest such plaintiffs would be stuck with the costly, though reasonable, bill of McDonald's lawyers.[249] Because the United States allows for a contingent fee arrangement in the tort context, plaintiffs see the image flashing in their heads: "no win, no pay."[250] The English Rule would effectively change that image to: "no win, must pay." This is a different formulation altogether, one that a potential plaintiff would thoughtfully weigh. Under the American Rule, if a plaintiff loses a tort claim, he seemingly walks away unscathed.[251] However, as discussed above, this is not the whole truth. Society bears an enormous cost imposed by unwarranted legal fear. The defendant and the courts waste an enormous amount of time and resources that could have been spent elsewhere.[252] Thus, unlike the English Rule, the American Rule tends to breed risky conduct and erode the notion of personal responsibility, which leads to inefficient behavior by product makers and retailers and seems to assist in the development of inefficient laws.

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[246] *See id.*

[247] *See id.*

[248] *See id.*

[249] This is under the assumption that the plaintiff has a 3% chance of winning at trial.

[250] Herbert M. Kritzer, *Fee Arrangements and Fee Shifting: Lessons from the Experience in Ontario*, 47 LAW & CONTEMP. PROBS. 128, 130 (Winter 1984). The "no win, no pay" image is one example of how foreigners view the contingency fee system in tort cases. *See id.*

[251] This is assuming that a contingency fee arrangement has been made.

[252] If a plaintiff wins a case with a low probability of victory, like the McDonald's suits above, then there would be a paradigm shift from "personal responsibility" to "someone else is responsible for my actions." This shift would cause companies, like McDonald's, not to be driven solely by consumer demand but to now spend resources on shouldering the responsibility burden for the consumers.

### D. *The Fee-shifting Personal Responsibility Model*

In the last section, the phrase "personal responsibility" was used to mean taking responsibility for one's own actions. However, in the tort context, the phrase "personal responsibility" goes a step further. Professor Cook first advanced the idea of "personal responsibility" in the tort context to mean:

> that each individual should bear the responsibility for those personal injury losses that she suffers. Hence, the appropriateness of the term "personal responsibility." It is "personal" because individuals look to themselves as the source of provision, not casting about to others or to society at large; it is "responsibility" because it imposes on individuals an obligation to take appropriate and available steps to provide for their own future losses.[253]

Such an efficient individual standard should be commended and promoted. The Cook "personal responsibility model" is developed here into a new model: the "fee-shifting personal responsibility model." This model provides that when a fee-shifting scheme exists potential victims will be more prone to take proper precautions ex ante, in the form of insurance and reasonable care, making the need to seek reimbursement through the courts a potentially futile and costly exercise and thereby choose not to file suit.

Consider the following scenario under the American Rule:

> **(Example H).** A potential plaintiff is injured in a two-car accident. The potential plaintiff believes that he has less than a 50% chance of winning at trial. Because his attorney has agreed to take the potential plaintiff's case on a contingency fee basis and the potential plaintiff sees filing suit as no cost and no risk, the potential plaintiff becomes an actual plaintiff and files suit against the defendant. Under the American Rule, the plaintiff has no incentive to take precautions to protect himself in the event of an

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[253] Douglas H. Cook, *Personal Responsibility and the Law of Torts*, 45 AM. U. L. REV. 1245, 1249 (June 1996). Professor Cook argues that his notion of "personal responsibility" should replace that of the current tort system. This author does not advance such a proposition but recognizes that the notion of "personal responsibility"—taking the appropriate steps ex ante to protect against possible torts—is an economically efficient action. Professor Cook does not address the concept of fee shifting in his article.

injury ex ante, either in the form of insurance or proper care, since he is able to risk nothing ex post and possibly get reimbursed for any loss that he may have suffered by the defendant.

Now, consider the following scenario under the English Rule:

**(Example I).** A potential plaintiff is injured in a two-car accident. The potential plaintiff believes that he has less than a 50% chance of winning at trial. Knowing in advance of the accident the probability that he would have to pay the attorneys' fees of a defendant in a potential tort action, the potential plaintiff purchases the appropriate insurance ex ante to protect himself against any possible future loss. In this case, the potential plaintiff is covered by a group health insurance policy, which pays all or most of his medical expenses. The potential plaintiff also has automobile insurance, which pays for the damage to his vehicle[254] and also covers any medical expenses not covered by his health insurance policy because of a co-payment or deductible. In addition, the potential plaintiff is covered by a disability insurance policy that will reimburse him for all or a significant part of any lost wages suffered because of the accident. The potential English Rule plaintiff is made whole without having to pursue a tort remedy. Thus, the potential English Rule plaintiff is not likely to file suit in this case because he has already been made whole and does not wish to risk paying the defendant's attorneys' fees in the event of a loss.[255]

The English Rule incentivizes a potential plaintiff to provide for the eventuality of incurring medical expenses or lost wages from whatever cause may befall him by purchasing the appropriate insurance policy ex ante. Such insurance policies are widely available and relatively inexpensive.[256] On the other hand, the American Rule

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[254] If in fact the injury was determined to not be the fault of the potential plaintiff, the potential defendant's automobile insurance policy will cover the costs of the damaged vehicle. If the potential defendant is uninsured, the potential plaintiff's uninsured motorist provision will cover the costs of the damaged vehicle without penalty.

[255] *See* Cook, *supra* note 253, at 1248-49, 1273-74.

[256] Professor Rahdert sums up the widespread availability of various types of insurance coverage that can be utilized by a potential plaintiff:

> First-party health and/or accident insurance is now widely available to many potential victims, usually through the relatively efficient mechanism of group policies maintained by employers. First-party insurance for accidental health is also widely available. Life insurance

discourages such behavior. An American Rule potential plaintiff does not see the benefit of taking proper precautions, either through good behavior or an insurance policy, knowing full well that he can take action ex post at no risk and no cost through a contingency fee arrangement.

Put simply, the American Rule creates a type of moral hazard. Professor Lloyd Cohen captures the essence of the moral hazard problem perfectly: "Moral hazard refers to the tendency of people to change their behavior if some of the downside risks of that behavior are borne by others rather than themselves, as when those risks are covered by insurance."[257] David Friedman discusses moral hazard and its relationship to insurance:

By buying insurance, you transfer the benefit of precautions against fire and the cost of risky behavior, such as smoking near piles of waste paper, from you to the insurance company. Precautions now have a large positive externality, so you take inefficiently few; risks have a large negative externality, so you take inefficiently many.[258]

Because of the moral hazard problem, insurance companies try to design their policies in ways that reduce the problem, such as specifying precautions that an insured must take.[259] The American Rule serves as a type of insurance and allows individuals to take greater risks than they would under the English Rule because they know they are protected. Figure 2 below demonstrates the level of care and the amount of insurance purchased under the English Rule and the American Rule.[260] With a fee-shifting scheme in place, a potential plaintiff engages in $C_1$ units of care. Under the American

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> of one form or another is very common. Disability insurance is also widely available and usually very inexpensive, although it is notably underused. Together, these kinds of insurance could cover the most immediate costs that accidents cause . . . . Most Americans probably either have or could purchase most of these kinds of insurance.

Mark C. Rahdert, COVERING ACCIDENT COSTS: INSURANCE, LIABILITY, AND TORT REFORM 42, 133 (Temple Univ. Press 1995).

[257] Lloyd R. Cohen, *The Human Genome Project and the Economics of Insurance: How Increased Knowledge May Decrease Human Welfare, and What Not To Do About It*, ANNUAL REVIEW OF LAW AND ETHICS, 7 219, 221 (1999); *see also* Economist.com, Economics A-Z, http://www.economist.com/research/Economics/alphabetic.cfm?LETTER=M (last visited Mar. 31, 2007) ("Moral hazard means that people with insurance may take greater risks than they would do without it because they know they are protected, so the insurer may get more claims than it bargained for.").

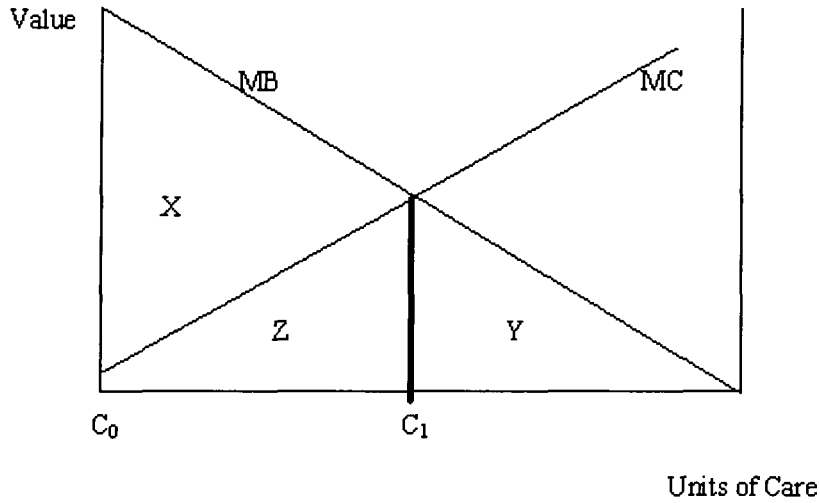
[258] FRIEDMAN, *supra* note 70, at 66.

[259] *Id.* at 66-67.

[260] *See* RICHARD IPPOLITO, ECONOMICS FOR LAWYERS 1, 250, 264-66 (Princeton University Press 2005) (discussing moral hazard and using a similar figure (8-1) to demonstrate the level of care with fire insurance).

Rule and assuming a contingent fee arrangement is available, the potential plaintiff chooses zero units of care, $C_0$.

**Figure 2**




Under the English Rule, a potential plaintiff will engage in proper care by not engaging in risky behavior and by purchasing the appropriate insurance in anticipation of any future accidents, ($C_1$).[261] This is the point at which the marginal cost (*MC*) of more care, including the purchase of insurance, equals the marginal benefit (*MB*).[262] The cost of engaging in this level of care is depicted by area *Z*.[263] The benefits in terms of the reduced filing of unnecessary suits is depicted by area *X*.[264]

Under the American Rule, the potential plaintiff believes that he can be made whole after the alleged tortious conduct, so the American Rule potential plaintiff does not engage in the same level of care as the English Rule potential plaintiff because recovering ex

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[261] *See id.* at 265.

[262] *See id.* at 265.

[263] *See id.* at 265.

[264] It is not worth it for the potential plaintiff to engage in a level of care beyond C1 because the marginal cost of care to reduce the need to file suit outweighs the benefit. *See* IPPOLITO, *supra* note 260, at 264-66 for a similar analogy.

post imposes no cost on the American Rule plaintiff.[265] Thus, the cost of filing suit for an American Rule plaintiff is $C_0$ or zero.[266] Hence, why should the American Rule potential plaintiff engage in "personal responsibility," thereby incurring the cost of optimal care and insurance, when he does not receive any benefit in doing so? The American Rule creates a disincentive to exercise optimal care, either in the form of personal behavior and decision-making or purchasing insurance, thereby increasing the likelihood that an American Rule potential plaintiff will file suit to regain his losses.[267]

The English Rule, by promoting the "fee-shifting personal responsibility model," is a much more efficient tort scheme than the one advanced by the American Rule. One shortfall of the "fee-shifting personal responsibility model," however, is the failure to take into account the recovery of non-pecuniary damages. Nonetheless, an English Rule plaintiff that suffers non-pecuniary damages and is otherwise compensated for all other losses through insurance may reasonably decide to forego the pursuit of such damages. Notwithstanding the non-pecuniary shortfall, individuals that are harmed under the English Rule are more prone to have taken the proper precautions ex ante to compensate themselves for their pecuniary loss, potentially making the onerous load of having to recover through litigation unnecessary. The English Rule potential plaintiffs are thus made better off. They no longer have to spend a vast amount of time ex post to be made whole when they could be more efficiently made whole ex ante. Society is also made better off because individuals take better care of themselves[268] and insure themselves against potential accidents, and the court system is not flooded with nonsensical and futile tort actions, freeing the justice system to hear more important matters.[269]

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[265] For example, the American Rule potential plaintiff can engage in risky behavior, such as eating four Big Macs a day and smoking four packs a day, and not purchase disability insurance. The American Rule potential plaintiff knows that he can shift the blame and make a no-risk attempt to recover for the losses suffered by his obesity and lung cancer. The American Rule potential plaintiff also knows that he does not need to waste his money on disability insurance since he can attempt to recover such lost wages ex post at no cost in a suit against a potential tortfeasor.

[266] *See* IPPOLITO, *supra* note 260, at 266 for a similar analogy.

[267] Notwithstanding the fact that American Rule potential plaintiffs act as though the marginal benefits of care are zero, the socially optimal level of care is still C1.

[268] Individuals are motivated to take care of themselves under the "fee-shifting personal responsibility model" for two reasons: (1) to avoid incurring an increase in premiums for a pattern of risky behavior; and (2) to avoid the physical and financial consequences of risky behavior because shifting the blame and being compensated for such risky behavior is increasingly difficult under an English Rule tort scheme.

[269] *See* Cook, *supra* note 253, at 1248-49, 1274.

## *X. Conclusion*

At the beginning, this article asked what is the best and most appropriate approach to fixing the American tort system? The economic analysis developed in this article is quite revealing. It was first established that the main purpose of an efficient tort system should be to reduce the risk of accidents through proper incentives. It was then established that this purpose could be accomplished at an optimal level under the general negligence rule when a tortfeasor is held liable for the full costs of an accident that he causes, including non-pecuniary damages. This is because a potential tortfeasor will have the proper incentives to consider the complete range of consequences of his actions if he will be required to pay damages equal to the damages imposed upon the victim. The economic model of game theory further revealed that any tort system that does not incentivize optimal behavior would lead to either too many accidents or too much care in the form of costly investments by the potential victim.

Through the use of these developed economic theories, this article has predicted two results of capping non-pecuniary damages in medical liability suits: the number of medical errors will increase and the cost of medical care will decrease. A preferred alternative to capping non-pecuniary damages would be to derive statutory valuations of non-pecuniary losses ex ante that attempt to accurately reflect the loss imposed upon a victim. With no liability cap and a proper set of statutory valuations, a potential tortfeasor would be properly incentivized to engage in the socially optimal, moderate level of care because he would be held liable for the full amount of harm imposed upon the victim. Moreover, statutory valuation would also accomplish the feat of decreasing the cost of medical care since tortfeasors would be liable for actual damages, not an inflated amount, which doctors overcompensate for in the current tort scheme in the form of higher premiums.

Through the use of the three known efficiency criteria, the Pareto criterion, the Kaldor-Hicks criterion, and the Nash-Rawls criterion, this article analyzed the efficiency of a change from the existing tort scheme to one of capping damages and the efficiency of a change from the existing tort scheme, which is governed by the American Rule, to one governed by the English Rule. The results of the Pareto efficiency analysis revealed that limiting the amount of damages a tortfeasor must pay below actual damages does not make the victim whole and in fact makes the victim worse off than before

the negligent act occurred. Likewise, such a change would neither be Kaldor-Hicks efficient nor Nash-Rawls efficient since the amount of money available remains unchanged and the schemes would be indistinguishable from an efficiency standpoint. On the other hand, a change from the American Rule to the English Rule shifts litigation costs to the losing party, thereby leaving the winning party no worse off than before the suit. Thus, a change from the American Rule to the English Rule would be a Pareto-efficient change. Likewise, under both Kaldor-Hicks and Nash-Rawls, a change from the American Rule to the English Rule would be efficient under the presumption that the winning party is entitled to have the losing party pay the winner's attorney's fees since the amount the losing party would have to pay under such a presumption would be an additional sum.

Undoubtedly, some kind of tort reform is needed to repair the broken down American tort system. The social cost upon America has reared its ugly head. Notwithstanding the adoption of statutory valuation for non-pecuniary damages, this article has revealed that the time is now for the United States to make a shift to the English Rule and no longer be the only industrialized nation in the world to abide by the economically inefficient American Rule, requiring the payment of an equivalent of a five percent tort tax on wages, an amount two-and-a-half times higher than the average of most foreign industrialized nations.[270]

In this article, I have argued in favor of a shift from the American Rule to the English Rule through the use of economic theory as an approach to tort reform and have reached several theoretical conclusions. First, American Rule plaintiffs are more likely to file frivolous suits and suits with a low probability of victory than are English Rule plaintiffs. On the other hand, the English rule actually discourages the filing of weak or frivolous suits. Second, while settlement may not be as likely to occur under the English Rule as under the American Rule, simply because plaintiffs will tend to vigorously pursue cases to the end of trial where the probability of victory is high, the English Rule encourages potential tortfeasors to take the optimal amount of care. Consequently, future behavior will improve and the overall volume of litigation will decrease, which will be exacerbated due to the decreased filings of low probability suits.

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[270] Although as stated above, statutory valuation, with the combination of a fee-shifting scheme, would be a powerful punch in creating an efficient tort system. *See* Kritzer, *supra* note 22, at 1946, 1947; EPSTEIN, *supra* note 22, at 902, 903 ("[T]he American practice on this point stands virtually alone among the advanced industrialized nations . . . .").

Third, the American Rule leads to inefficient and risky behavior, could lead to inefficient legal precedent, and diminishes the acceptance of personal responsibility. Finally, under the English Rule, potential victims are more prone to take proper precautions ex ante, in the form of insurance and proper care, making the need to seek reimbursement through the courts a potentially futile exercise, a theory I have developed as the "fee-shifting personal responsibility model." As legislators and policy makers look for tort reform solutions, the economic efficiency analysis in this article provides a clear answer: steer away from capping damages and embrace a shift to the English Rule.