



**Opting for the British Rule, or If Posner and Shavell Can't Remember the Coase Theorem, Who Will?**

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## COMMENTARY

### OPTING FOR THE BRITISH RULE, OR IF POSNER AND SHAVELL CAN'T REMEMBER THE COASE THEOREM, WHO WILL?

John J. Donohue III\*

Consider a hypothetical involving the decision to settle or try a lawsuit. The plaintiff has brought a tort action against the defendant, and the parties have agreed to attempt to settle. Will the legal rules governing the assignment of trial costs affect the likelihood of settlement? In other words, will the parties be any more likely to settle the case if their suit is pending in a jurisdiction operating under the American rule, under which parties must bear their own legal expenses, rather than in one operating under the British rule, under which the losing party must pay the legal expenses of both parties?

There is now an immense literature analyzing this question.<sup>1</sup> In his first foray into this field, Judge Richard Posner concluded that the greater risk associated with the British rule — parties can win more or lose more under this rule than under the American rule — would lead risk-averse litigants to settle more cases.<sup>2</sup> Subsequently, Judge

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<sup>1</sup> Among the important contributions are R. POSNER, *ECONOMIC ANALYSIS OF LAW* 537-42 (3d ed. 1986); Cooter, Marks & Mnookin, *Bargaining in the Shadow of the Law*, 11 J. LEGAL STUD. 225 (1982); Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973); Hause, *Indemnity, Settlement, and Litigation, or I'll Be Suing You*, 18 J. LEGAL STUD. 157 (1989); Katz, *Measuring the Demand for Litigation: Is the English Rule Really Cheaper?*, 3 J.L. ECON. & ORG. 143 (1987); Landes, *An Economic Analysis of the Courts*, 14 J.L. & ECON. 61 (1971); Miller, *An Economic Analysis of Rule 68*, 15 J. LEGAL STUD. 93 (1986); P'ng, *Strategic Behavior in Suit, Settlement, and Trial*, 14 BELL J. ECON. 539 (1983); Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973); Priest, *Regulating the Content and Volume of Litigation*, 1 SUP. CT. ECON. REV. 163 (1982); Priest & Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984); and Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982). For an excellent survey, see Cooter & Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067 (1989). See generally *Attorney Fee Shifting*, LAW & CONTEMP. PROBS., Winter 1984, at 1 (symposium) (presenting a number of studies analyzing the fee-shifting issue).

<sup>2</sup> See Posner, *supra* note 1, at 428.

Posner and Professor Steven Shavell developed a model of the litigation decision to settle or try a case that produced the opposite result: the British rule would *reduce* the likelihood of settlement.<sup>3</sup> But Posner and Shavell reached this conclusion because they neglected the analysis outlined by Ronald Coase thirty years ago in his path-breaking article, *The Problem of Social Cost*.<sup>4</sup> Indeed, despite the number of economists and law and economics scholars who have exhaustively examined this question, not one has realized that the Coase theorem would govern under the assumptions that motivate the Posner and Shavell analyses.

This Commentary demonstrates that an application of the Coase theorem to the Posner/Shavell model yields the conclusion that the rate of settlement will be identical under the American and British rules.<sup>5</sup> In addition to supplying a new theoretical solution to the fee-shifting controversy, this Commentary argues that the failure of the most renowned figures in law and economics to apply the Coase theorem in this context may have important implications for our understanding of the practical impact of the Coase theorem and may provide evidence that profitable opportunities can be neglected in the marketplace for long periods of time.<sup>6</sup>

Part I begins by setting forth the argument of Posner and Shavell that the British rule leads to fewer settlements. Their innovative and creative analysis is correct on its own terms only when litigants are prohibited from altering the legal rule governing the allocation of

<sup>3</sup> See R. POSNER, *supra* note 1, at 537-40; Shavell, *supra* note 1, at 65.

<sup>4</sup> Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). The Coase theorem states that parties will reach the identical, efficient outcome as long as they are free to bargain costlessly around the operative legal rule and there are no wealth effects associated with the assignment of the legal entitlement.

<sup>5</sup> As always, the Coasean identity prediction can only be expected to hold when transaction costs are zero.

<sup>6</sup> Additional evidence is provided by Faulhaber and Baumol, who discuss the sluggish pace at which firms have adopted the method of discounting future cash flows to determine the present value of capital projects:

[T]he evidence suggests that the invention of the net present value calculation [in 1907 by Irving Fisher] has been disseminated among practitioners rather slowly, and even today its use is far from universal. Though a very old idea by the standards of today's economist and thoroughly incorporated into the capital budgeting methods of many large firms and public agencies, explicit use of the net present value of the expected income stream of costs and yields associated with an investment is still shunned completely by almost half the large firms surveyed [in 1978].

Faulhaber & Baumol, *Economists as Innovators*, 26 J. ECON. LITERATURE 577, 585 (1988). The authors conclude that "the market usually gets it approximately right — eventually." *Id.* at 579. But "eventually" can be a long, long time.

One might suggest, though, that the proper test of whether firms are effectively profit-maximizing does not look at whether they appear to discount properly, but inquires whether firms that do not use correct discounting methodology make less profitable investments than firms that do.

litigation costs. Part II shows that, in the absence of such a prohibition, a proper interpretation of the Posner/Shavell model yields the conclusion that the settlement rate will be unaffected by the legal rule because the parties will contract around the standard to maximize their expected wealth. This conclusion will hold regardless of whether the parties are risk averse, whether the use of the British rule will cause parties to expend greater sums on litigation, and whether plaintiffs will frequently be judgment-proof and therefore unable to reimburse prevailing defendants.

Part III discusses the implications of the conclusions in Part II for our understanding of the Coase theorem and the likelihood that individuals will recognize Coasean bargaining opportunities and act on them. Because the Coase theorem predicts that the rate of settlement will be identical under the American and British rules, empirical evidence indicating that the legal rule does influence the rate of settlement<sup>7</sup> may suggest that, at least in some instances, virtually everyone overlooks the bargaining opportunities that are essential to drive Coasean invariance predictions. The failure of two of the towering figures of the law and economics community to recognize the possibility of contracting around the legal rule illustrates the difficulty of perceiving Coasean bargaining opportunities. Therefore, we should not be surprised if such opportunities are frequently overlooked in many contexts, unless we are convinced that the incentives to generate accurate conclusions in legal scholarship are inherently weaker than the wealth-maximizing incentives of litigants and market participants.

Alternatively, litigants may be more perceptive than the scholars,<sup>8</sup> recognizing the possibility of the type of private law restructuring discussed in this Commentary but rejecting it because of possible legal impediments or the belief that the transaction costs involved in restructuring are simply too high. But the controversy over whether the lack of rule-shifting is explained by legal or cost impediments or by ignorance may soon be put to the test: once the theory set forth in this Commentary becomes known, litigants may begin to act in ac-

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<sup>7</sup> Compare Coursey & Stanley, *Pretrial Bargaining Behavior Within the Shadow of the Law: Theory and Experimental Evidence*, 8 INT'L REV. L. & ECON. 161, 170-71 (1988) (finding that under the British rule the rate of settlement is higher than under the American rule) with Snyder & Hughes, *The English Rule for Allocating Costs*, 6 J.L. ECON. & ORGANIZATION 345 (1990) (concluding that the adoption of the British rule in Florida medical malpractice cases has lowered the settlement rate). Some of the empirical evidence on settlement and litigation has produced anomalous results. For example, one study that supports the Posner/Shavell prediction that the British rule would lead to a lower rate of settlement also found that higher litigation costs reduced the likelihood of settlement. See Fournier & Zuehlke, *Litigation and Settlement: An Empirical Approach*, 71 REV. ECON. & STATISTICS 189, 193 (1989).

<sup>8</sup> After all, economic actors have presumably been acting in Coasean fashion trying to bargain around legal rules for centuries, while the theorem only emerged from the academy 30 years ago.

cordance with its dictates. Such a response would reveal both that profitable opportunities in the marketplace are at times overlooked for long periods of time and that economic theory has the ability not just to describe behavior, but to shape it as well. On the other hand, if litigants do not begin to shift fee allocation rules in the manner outlined by this Commentary, that would suggest that profitable opportunities are not likely to be overlooked for considerable periods of time.<sup>9</sup> In this event, we will be left to conclude either that the Posner/Shavell model of litigation is flawed or that the transaction costs in rule-switching are prohibitively high.

## I. THE ARGUMENT OF POSNER AND SHAVELL

### A. *The Theoretical Model*

Posner and Shavell begin with the assumption that the parties in litigation will estimate in economic terms how they will fare if they proceed to trial.<sup>10</sup> To keep matters simple, assume that only three factors are relevant to this determination: the probability of plaintiff's success at trial, the amount in controversy, and the litigation costs of both parties. Accordingly, let  $P_p$  be the plaintiff's estimate of his probability of success at trial,  $P_d$  be the *defendant's* estimate of the *plaintiff's* probability of success at trial,  $D$  be the damages to be awarded if the plaintiff is successful, and  $C_p$  and  $C_d$  be the trial costs incurred by the plaintiff and defendant, respectively.<sup>11</sup> We can now formally define the expected net benefits to the plaintiff and the expected costs to the defendant under the American and British rules.

*The American Rule:* The expected benefit to the plaintiff and the expected cost to the defendant of going to trial are given by:

$$(1) EB_p = P_p \times D - C_p$$

$$(2) EC_d = P_d \times D + C_d.$$

Posner and Shavell both assume that the case will be settled whenever  $EB_p < EC_d$ , because in this event a settlement figure can be reached that will leave both parties better off than they expect to be if they were to proceed to trial. Therefore, the condition for settlements is:

<sup>9</sup> Because the "ignorance thesis" will soon be verified or disproved, I feel free to advance the position more boldly than would be the case when a strong claim could not be falsified so readily.

<sup>10</sup> See R. POSNER, *supra* note 1, at 523; Shavell, *supra* note 1, at 56.

<sup>11</sup> One obvious extension of this model is to assume that the parties do not know the amount of damages with certainty. Introducing this complexity, however, would not change any of the fundamental conclusions of this Commentary.

$$(3) P_p \times D - C_p < P_d \times D + C_d, \text{ or equivalently,}$$

$$(4) P_p - P_d < (C_p + C_d) \div D.$$

*The British Rule:* The requirement that the losing party must pay the legal costs of both parties will affect the expected costs and benefits of trial. Specifically, each party's expected trial costs will simply be its estimate of the probability of losing —  $(1 - P_p)$  for the plaintiff,  $P_d$  for the defendant — multiplied by the sum of  $C_p$  and  $C_d$ . Using this fact, we can compute the expected benefit to the plaintiff and expected cost to the defendant of proceeding to trial:

$$(5) EB_p = P_p \times D - (1 - P_p)(C_p + C_d)$$

$$(6) EC_d = P_d \times D + P_d(C_p + C_d).$$

Once again, the condition for settlements is that  $EB_p < EC_d$ , or

$$(7) P_p \times D - (1 - P_p)(C_p + C_d) < P_d \times D + P_d(C_p + C_d).$$

Rearranging terms yields the following condition:

$$(8) P_p - P_d < (1 - P_p + P_d)(C_p + C_d) \div D.$$

The first point to note about inequalities (4) and (8) is that, if  $P_p = P_d$ , the two conditions are equivalent. In other words, the outcome under the American and British rules will be identical when the parties have the same views about the likelihood of success at trial.<sup>12</sup> Second,

<sup>12</sup> Some intellectual history may be useful here. Conversations with some of the scholars working in this area have indicated that this identical outcome, which results from both parties having identical beliefs about the outcome of the trial, has frequently been perceived as the "Coasean" outcome. From this perspective, the Posner/Shavell model is superior to the so-called "Coasean" analysis because it both realistically permits the opposing parties to have different assessments about the probability of success at trial and because it escapes the obviously incorrect conclusion that all cases will settle (as they will in this analysis if the probability assessments are identical). The argument is then raised that by returning to a Coasean analysis, I am not fully appreciating the advance that Posner/Shavell have made.

This argument is based on a misconception of the nature of a Coasean analysis. The Coase theorem does not work only if the parties agree on the likelihood of success at trial (or, for example, on the likely damages resulting from pollution emission by a factory). With zero transaction costs, the identical outcome will be reached in both of these scenarios regardless of whether the parties share the same beliefs. The assumption in the litigation context that the parties have identical beliefs does lead to a prediction that all cases will settle regardless of the legal rule on cost allocation, but this is a Coasean analysis only in the degenerate sense that the parties are seeking to bargain to reach efficient outcomes. The defining characteristic of a Coasean analysis is not that identical outcomes are reached in a bargaining setting (as they are in the litigation model with identical beliefs), but rather that parties are able to bargain around some legal rule or assigned entitlement (which is the case in the analysis provided in this Commentary). Thus, Posner and Shavell did not advance beyond a Coasean analysis; they never reached such an analysis in the first place. I should hasten to add that nothing said here diminishes the value of the contribution that Posner and Shavell did make in showing that differing expectations were necessary to model the decision to settle or litigate and how that model would operate if parties were forced to rely on either a British or American rule of cost

because inequalities (4) and (8) differ on the right-hand side, it is clear that, when  $P_p$  and  $P_d$  are not equal, the conditions for settlement are different under the American and British rules. It is not immediately apparent, though, whether the shift from the American system to the British system will increase or decrease the likelihood of settlement in this model.

### B. An Empirical Extension

To simplify somewhat the interpretation of the above Posner/Shavell conditions for settlement, one can make use of the stylized fact that total costs are roughly half of total damages in tort litigation.<sup>13</sup> In other words,  $(C_p + C_d) \div D = 0.5$ . Substituting this equality into inequalities (4) and (8) yields the following conditions for settlement:

*The American Rule:*

$$(9) P_p - P_d < 0.5.$$

*The British Rule:*

$$(10) P_p - P_d < (1 - P_p + P_d) \times 0.5, \text{ which is equivalent to:}$$

$$(11) P_p - P_d < 0.33.^{14}$$

Under both legal regimes, whenever the plaintiff is less optimistic than the defendant about the plaintiff's chance of success — that is, if  $P_p < P_d$  — the case will settle because conditions (9) and (11) will be satisfied. Thus, we need only concern ourselves with cases in which  $P_p > P_d$  — cases in which the parties are both relatively optimistic. Inequality (9) indicates that, under the American system, the difference between the plaintiff's and defendant's estimates of the plaintiff's probability of success at trial will have to exceed 0.5 before a trial will occur. Inequality (11) reveals that, under the British system, the range of disagreement within which settlement will occur shrinks to only 0.33.<sup>15</sup> In other words, as Posner and Shavell have

allocation. My Coasean argument in this Commentary clearly builds upon their model, and therefore I am in their debt for their path-breaking and foundational work.

<sup>13</sup> See J. KAKALIK & N. PACE, COSTS AND COMPENSATION PAID IN TORT LITIGATION 69 (1986). The ratio of total litigation costs to damages would doubtless be substantially smaller than 0.5 in major corporate litigation.

<sup>14</sup> It might appear that the step from condition (10) to condition (11) implies that  $1 - P_p + P_d = 0.67$ . This is not the case, as one can see by letting  $X = P_p - P_d$  and solving for  $X$ .

<sup>15</sup> The reason for this shrinking settlement range can be illustrated by rearranging inequality (8) — dividing each side by  $(1 - P_p + P_d)$  — and comparing it to inequality (4). The set of combinations of  $P_p$  and  $P_d$  that will generate a settlement range necessarily shrinks because, with one exception, the term  $(P_p - P_d) \div (1 - P_p + P_d)$  is necessarily greater than the term  $P_p - P_d$  for all possible probabilities (in which  $P_p > P_d$ ). The single exception is when  $P_p - P_d = 1$ , because division by zero is impermissible. In this case — when  $P_p = 1$  and  $P_d = 0$  — there is no possibility of settlement under either the American or British rules, given the level of trial costs assumed in this example, because  $P_p - P_d > 0.5$ .

stressed, one would expect the rate of settlement to fall if the United States were to adopt the British rule on fee-shifting.

According to the Posner/Shavell framework, the opportunity to avoid litigation costs serves as an inducement to settle. For this reason, avoided litigation costs can be thought of as a bribe to settle. But note that the size of the bribe will be different under the American and British rules even when the underlying litigation costs to be avoided are identical. Under the American rule, the parties know that the size of the bribe is exactly equal to  $C_p + C_d$  because the plaintiff expects to save  $C_p$  and the defendant expects to save  $C_d$  if the case settles. Under the British rule, however, optimistic parties will perceive the size of the bribe to shrink because they expect to win, thereby avoiding all litigation costs; settlement will be expected to save the plaintiff  $(1 - P_p)(C_p + C_d)$  and save the defendant  $P_d \times (C_p + C_d)$ . In other words, the bribe to settle is only  $(1 - P_p + P_d)(C_p + C_d)$  under the British rule, which will be less than the American-rule bribe whenever  $(1 - P_p + P_d) < 1$ .<sup>16</sup> We know that, for the cases of interest, this term is less than 1, because we have limited ourselves to the situation in which  $P_p > P_d$ . (Otherwise, the case will settle in any event, as noted above.<sup>17</sup>)

## II. INTRODUCING THE COASE THEOREM

The previous analysis has ignored an important lesson from Coase's 1960 article. One cannot simply examine the effects of legal regimes without considering the ability of the affected parties to reorder the apparently fixed environment. Regardless of which legal rule nominally applies, the parties can assess the expected benefits and costs from litigation under the two rules and agree to be governed by the one that is more favorable to them. If American-rule litigants find that they would be better off with a British rule, they can simply agree to shift fees to the losing party should the case go to trial. As I show below, the nominal legal rule will not affect the rate of settlement. Any time a case would settle under the American rule but not under the British rule according to the Posner/Shavell analysis, the parties would be better off *litigating* the case under a self-imposed British rule. This result may seem counter-intuitive, but it simply follows from the Coase theorem.

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<sup>16</sup> Note that the full trial costs of  $C_p + C_d$  will still be borne if a trial takes place under the British rule, but because the parties are both relatively optimistic, they each expect the other party to bear a disproportionate share of these costs. The result of this relative optimism is that the apparent benefit from settling has shrunk under the British rule, even though the actual total trial costs avoided are still  $C_p + C_d$ .

<sup>17</sup> The conditions for settlement under both rules — inequalities (9) and (11) — always hold if  $P_p < P_d$ .



### A. A Numerical Example

An example will help to clarify the issues. Consider a case in which  $P_p = 0.7$  and  $P_d = 0.25$ . The amount in controversy is \$1000 and trial costs are \$250 for each party.<sup>18</sup> Because  $P_p - P_d = 0.45$  in this case, the prior analysis indicates that there will be a settlement under the American rule — condition (9) holds — but not under the British rule — condition (11) fails. The parties in the two jurisdictions would assess such a case in the following manner.

*The American Rule:* The expected benefit to the plaintiff and the expected cost to the defendant of going to trial are given by:

$$(12) \text{EB}_p = 0.7 \times 1000 - 250 = 700 - 250 = \$450$$

$$(13) \text{EC}_d = 0.25 \times 1000 + 250 = 250 + 250 = \$500.$$

Because the plaintiff expects to get less from going to trial than the defendant expects to pay, a settlement somewhere between \$450 and \$500 will leave both parties better off.

*The British Rule:*

$$(14) \text{EB}_p = 0.7 \times 1000 - (1 - 0.7) \times 500 = 700 - 150 = \$550$$

$$(15) \text{EC}_d = 0.25 \times 1000 + 0.25 \times 500 = 250 + 125 = \$375$$

Unlike the situation under the American rule, there is no settlement range here: the plaintiff would not accept any settlement below \$550 and the defendant would not offer any payment above \$375.

Although in the above hypothetical no settlement would be achieved under the British rule, we must note a fact that has so far escaped detection: according to their individual calculations of the expected costs and benefits, both parties would expect to fare better by going to trial under the British rule than either settling or going to trial under the American rule. For example, if the plaintiff in an American-rule jurisdiction were to go to trial, he would expect to receive \$450 — equation (12) — and if he secured the most favorable possible settlement he would receive \$500 — equation (13).<sup>19</sup> But by going to trial under the British rule, the plaintiff would expect to receive the greater sum of \$550 — equation (14). Similarly, if the defendant in an American jurisdiction were to go to trial, she would expect to pay \$500 — equation (13) — and if she received the most favorable possible settlement she would expect to pay \$450 — equation

<sup>18</sup> In this case,  $(C_p + C_d) \div D = 500 \div 1000 = 0.5$ . For expository ease, settlement costs are taken to be zero.

<sup>19</sup> This settlement is the most favorable possible to the plaintiff because he will capture all of the gain from settling; the defendant would be paying the same amount that she would expect to pay if the case were to go to trial. The (risk-neutral) defendant would not settle for more than this because she would expect to do better by simply trying the case.

(12). With a trial under the British rule, however, the expected cost to the defendant would only be \$375 — equation (15).

If both parties expect to be better off litigating under the British rule than they would be in settling under the American rule, they can simply agree through private contract to litigate their dispute under a fee-shifting arrangement. Because Posner and Shavell's assumptions guarantee that both parties will expect to profit from this private agreement,<sup>20</sup> it would appear that the bargain would be struck, and the case would be tried under the British rule.

One might venture that transaction costs could be so high that rule-shifting would be infeasible. At a minimum, three steps are involved to accomplish the rule shift.<sup>21</sup> First, the parties must assess the likely trial outcomes under the two rules. Once the parties have

<sup>20</sup> The American-rule parties perceive that they will be better off trying their case under a British rule because of their incompatible and optimistic assessments of the likelihood that they will prevail at trial. In light of these expectations, the combined expected litigation costs of the two parties are considerably smaller than the combined litigation costs that will actually be expended. Therefore, there is no actual surplus to be gained by switching to the British rule, although there is a perceived surplus. In other words, although it is privately efficient for the parties to switch to the British rule under certain circumstances, it will not be socially efficient for them to do so.

One might attack the discussion by stating that parties would not be willing to persist in their incompatible and overly optimistic assessments of the likelihood of success if they realized that collectively (although perhaps not individually) they would have to be worse off by trying a case under the British rule that would settle under the American rule. Certainly, if in the course of negotiation one party proposed the switch to the British rule, it might cause the other side to reduce its estimate of its own likelihood of success. But this criticism is a fundamental criticism of the Posner/Shavell model, not my extension of it: in the typical Posner/Shavell example, if the parties decide to try the case under the American rule, they are acting in a way that may be privately efficient but not socially efficient. The costs of the trial can be avoided through settlement, and therefore the collective pie will necessarily be greater with settlement than with trial. But trials sometimes occur because parties hold inconsistent and overly optimistic predictions about the likelihood of success. Arguing that parties would realize on average that nothing is to be gained by rule-shifting and therefore would never do it is equivalent to stating that litigants would realize on average that nothing is to be gained from trying a case and therefore no case would ever be tried. Because cases are tried, either the criticism is without merit or the Posner/Shavell model is incorrect. Because I accept the Posner/Shavell framework as the basis for analyzing the rule-shifting case, the criticism cannot apply to my argument.

Although from the perspective of the parties it would appear to be socially inefficient to permit a case to be tried, this conclusion overlooks the incentive effects on litigants if hard bargainers did not have to face the prospect of trying their case. The threat of trial — under both rules, but particularly under the British rule — will deter parties who systematically overvalue their likelihood of success by making the agony of defeat somewhat more painful. This prospect should encourage future litigants to be more accurate in their probability assessments, which, other things being equal, is beneficial from a social perspective.

<sup>21</sup> In this illustration, trial under the British rule always dominates any settlement under the American rule for both parties. At times there will be a wealth effect associated with a shift from one rule to another. See *infra* p. 1105. In such cases, a side payment may be necessary to induce one party to abandon the current legal regime, thereby increasing the complexity and the cost of the transaction.

computed these expected costs and benefits under one rule, it is a trivial matter to plug the same estimates of the probabilities of success and costs into a slightly different equation.<sup>22</sup> Second, they must write the contract that effects the rule change. Again, this seems trivial: "The litigants agree that the losing party will reimburse the winning party for all reasonable attorneys' fees."<sup>23</sup> Third, they must consider whether the losing party might be able to challenge the agreement after trial or whether collecting the reasonable attorneys' fees might be costly. As I discuss further below,<sup>24</sup> it is fairly settled law in the context of pre-litigation agreements that contracts shifting attorneys' fees are enforceable, and these precedents would likely provide a solid legal foundation for rule shifts in the post-litigation context. Moreover, although there are record-keeping issues involved in establishing reasonable attorneys' fees, these impose relatively modest incremental burdens given modern billing procedures, and the court will bear the cost of deciding whether certain fees should be allowed.<sup>25</sup>

Indeed, if we dismiss the costs associated with rule shifts as inconsequential, the previous example can be generalized to the following proposition:

For any case in which the Posner/Shavell framework suggests that settlement will occur under the American rule but not the British rule, the parties would expect to be better off agreeing to try the case under the British rule.<sup>26</sup>

### *B. A Graphical Depiction of the Choice Between the Two Rules*

It may be useful to consider a graphical depiction of the numerical example that was discussed above. Figures 1-3 illustrate, for different estimates of  $P_p$  and  $P_d$ , the expected benefits and costs that the parties anticipate from trial under both the American and British rules, given

<sup>22</sup> The variables that Posner and Shavell assume that parties will develop in assessing whether to settle are the same under the two rules. Any party that can solve inequality (4) can with equal ease solve inequality (8).

<sup>23</sup> Alternatively, if the parties in a tort case agree that legal fees for a trial will be roughly \$10,000, their rule-shifting contract can specify a fixed amount. This latter approach might avoid disagreements about whether certain trial expenditures were necessary, thereby reducing the costs of enforcing the rule-shifting agreement.

<sup>24</sup> See *infra* note 38.

<sup>25</sup> The losing party will expend resources in reviewing the legal fees of the prevailing party, and a challenge to some of the expenses will likely generate additional costs for both parties. For a good summary of how the British-rule process of awarding fees works in England and in Alaska, which adopted the British rule for most civil actions in 1961, see A. TOMKINS & T. WILLING, *TAXATION OF ATTORNEYS' FEES: PRACTICES IN ENGLISH, ALASKAN, AND FEDERAL COURTS* 5-47 (1986).

<sup>26</sup> Ex ante they both *expect* to be better off given their estimates of their probabilities of success. In fact, settlement is preferable ex post since the parties avoid litigation costs.

the trial costs and amount in controversy employed in the above hypothetical. For example, Figure 1, which sets  $P_d$  at 0.25, reveals how changes in the plaintiff's estimate of his probability of success will affect the expected trial outcome for the different rules. Figure 2 provides this same information under the assumption that  $P_d = 0.5$ . One distinctive feature of Figure 2 bears mention: the expected cost to the defendant is identical under both the American rule and the British rule. Figures 1 and 3 show that this phenomenon is not generally true, but the discussion below will rely on Figure 2 in order to simplify the exposition of a number of important points, without altering any fundamental conclusions.

Settlements will occur in the Posner/Shavell framework whenever  $EB_p < EC_d$ . Figures 1-3 readily depict how various values of  $P_p$  and  $P_d$  will influence the possibility of settlement: whenever the line representing the expected benefit to the plaintiff lies below the line representing the expected cost to the defendant, the case will settle. Thus, Figure 2 reveals that when  $P_d = 0.5$  all cases would be expected to settle under an American rule, whereas only those cases for which

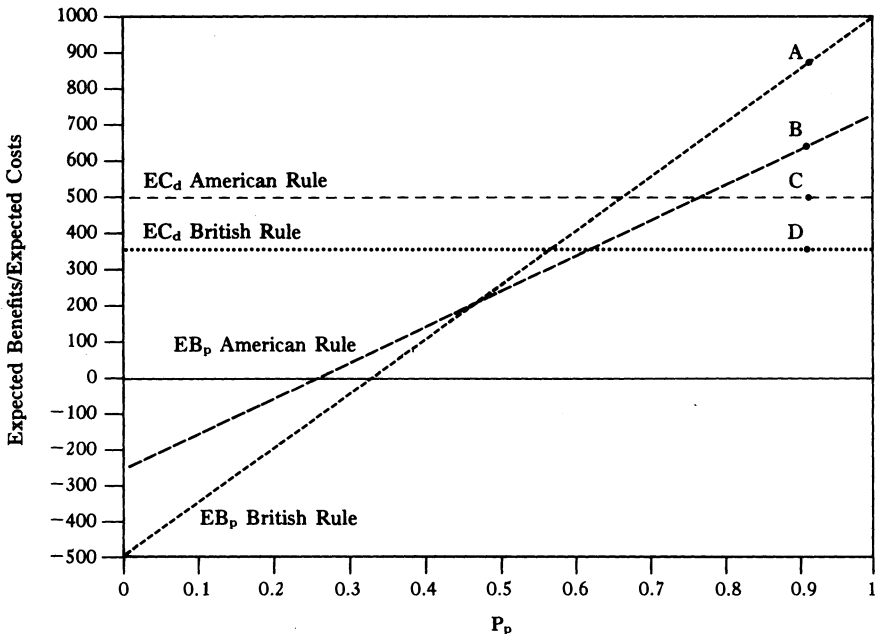


FIGURE 1  
 EXPECTED COSTS AND BENEFITS OF LITIGATION UNDER THE AMERICAN  
 AND BRITISH RULES  
 $P_d = 0.25$

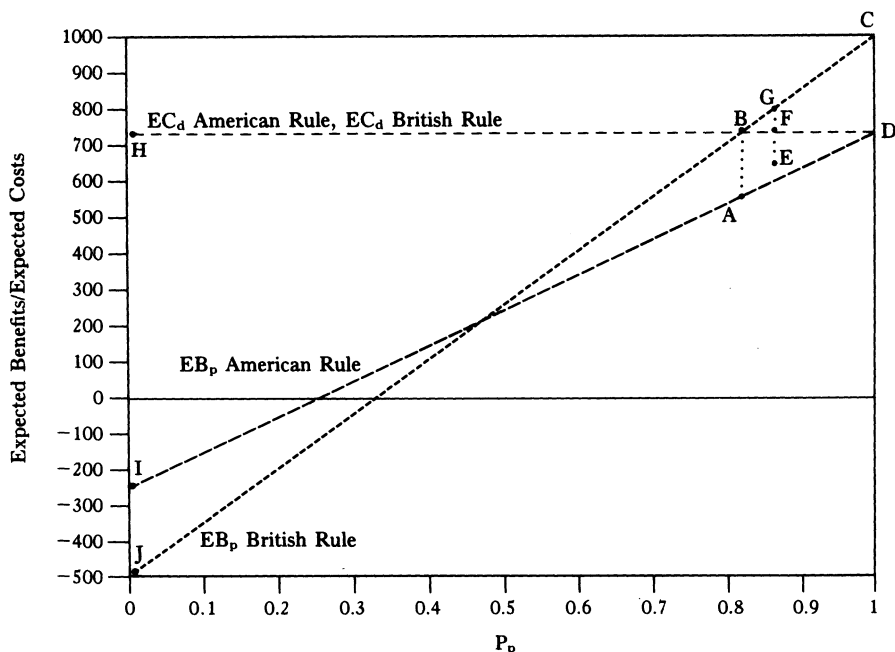


FIGURE 2  
EXPECTED COSTS AND BENEFITS OF LITIGATION UNDER THE AMERICAN  
AND BRITISH RULES

$$P_d = 0.5$$

$P_p < 0.833$  will settle under the British rule.<sup>27</sup> But as this Commentary has stressed, parties will not necessarily be satisfied with the rule of fee-allocation that their legislature has (implicitly or explicitly) bestowed upon them. If the parties perceive that they would do better under a different rule, they will select it. Because in Figure 2 the defendant expects to do exactly the same at trial under both the British and American rules, we will ignore the defendant for the moment. Plaintiffs, in contrast, who fall in the region to the right of point A — that is, those for whom  $0.833 < P_p \leq 1$  — will clearly prefer trying their cases under the British rule to trying them under the American rule. More important, they would also prefer *trying* their cases under the British rule to *settling* them under the American rule. Although the best that such a plaintiff can do in attempting to settle under the American rule is to push the defendant to her expected cost

<sup>27</sup> To the right of  $P_p = 0.833$  in Figure 2, British-rule plaintiffs expect to receive more from going to trial than defendants expect to pay, which prevents the parties from settling.

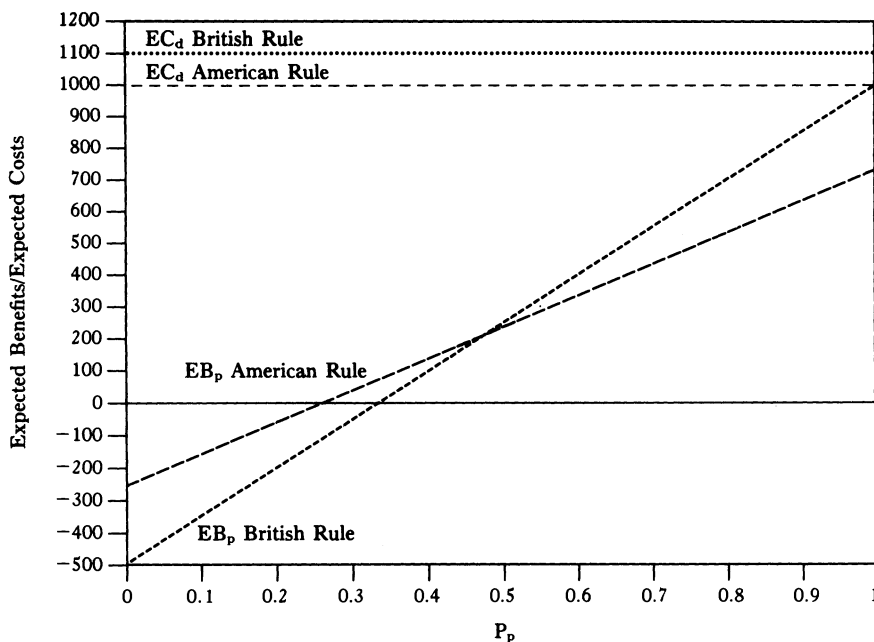


FIGURE 3

EXPECTED COSTS AND BENEFITS OF LITIGATION UNDER THE AMERICAN AND BRITISH RULES

$$P_d = 0.75$$

of \$750 (line segment BD), the plaintiff will be unambiguously better off going to trial with a contractual agreement to shift fees to the losing party, leaving the plaintiff on line segment BC. With the defendant equally well off and the plaintiff unambiguously advantaged, the shift to the British rule is inevitable given the assumptions of the Posner/Shavell model.

The reader will perhaps object to the preceding analysis. Suppose the parties, operating under an American rule, have agreed to settle by splitting the difference between their expected American-rule trial outcomes, ending up at some point within area ABD, such as E. Now the plaintiff will clearly prefer to shift via private contracting to the British rule, but the shift harms the defendant by forcing her to pay an expected cost of \$750, instead of the lower amount of the settlement.<sup>28</sup> Hence, it might seem that the parties will not agree to try the case under the British rule. The flaw in this critique is that

<sup>28</sup> Because E is below line segment BD, the defendant would prefer paying the amount that point E represents to paying the higher amount — \$750 — that line segment BD represents.

a side payment will readily overcome the defendant's reluctance. The shift from a settlement at E under the American rule to a trial under the British rule raises the expected wealth of the plaintiff by amount EG and lowers the expected wealth of the defendant by amount EF. Because the expected gain is greater than the expected loss, the parties will agree to try the case under the British rule and the defendant's acquiescence will be purchased with a side payment of at least EF dollars. In other words, the cases that, according to the Posner/Shavell analysis, would settle under the American rule but would be tried under the British rule will be tried regardless of the legal rule — the parties will simply impose a British rule on themselves if they happen to be in an American-rule jurisdiction.

To summarize the preceding discussion: in the Posner/Shavell framework, cases to the right of point B in Figure 2 — that is, cases in which the plaintiff's estimate of success at trial is greater than 0.833 — will settle for some point in the region ABD if the case is pending in an American-rule jurisdiction, but will be tried if the case is filed in a British-rule jurisdiction because the plaintiff will end up on line segment BC, which is more than the defendant will pay in settlement. But the parties need not be bound by the nominal legal rule of fee allocation. Whenever the parties in these American-rule cases would be tempted to settle in region ABD, they will both expect to do better by agreeing to try the case under a British rule. A side payment may be necessary to induce the defendant to agree to the shift, but if the parties can reach a settlement in the American-rule case — as Posner and Shavell assume that they will in this situation — they will perceive that they will both be better off with a British-rule trial and an appropriate division of the perceived surplus. This ostensible surplus is readily identified for any American-rule settlement point in regions ABD: for example, for point E, the surplus will be  $EG - EF$ ,<sup>29</sup> which is necessarily positive.<sup>30</sup>

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<sup>29</sup> EG is the distance from the American-rule settlement point to the British rule trial outcome line for the plaintiff — that is, the plaintiff's gain from the shift. EF is the distance from the American-rule settlement point to the British-rule trial outcome line for the defendant.

<sup>30</sup> It is also interesting to speculate about what would happen if the plaintiff's estimated probability of success were less than 0.833. Under the British rule, a settlement will presumably take place somewhere in region HJB, and under the American rule somewhere in region IJBA. Because settlements will result in both cases, the Coasean outcome is again preserved. Note that for cases just to the left of point B, the settlement range will be narrower under the British rule than under the American rule, but one would not expect parties to opt for a different rule when cases would settle in either event. The reason is that if parties were simply to shift legal rules to take advantage of a different bargaining range, they would be engaging in a zero-sum activity: whatever one gained by the shift, the other would lose. Therefore, there would be no perceived surplus to encourage the shift, as there is in the set of cases in which an American-rule settlement can be transmuted profitably into a British-rule trial.

Moreover, in a case in which settlement is impossible under the American rule, it can still be to the advantage of the parties to opt for the British rule. For example, consider the case

### C. Some Additional Considerations

Of course, one can immediately raise a number of objections to the preceding analysis, but it is helpful to separate the objections into two categories: criticisms that are directed essentially at the Posner/Shavell model of the decision to settle or litigate a claim and criticisms that object to the demonstration of the applicability of the Coasean invariance prediction to the Posner/Shavell model. For example, one might argue that asymmetric information and strategic behavior undermine the validity of the Posner and Shavell predictions. I readily concede that this may be true and, indeed, I have written elsewhere that some aspects of the standard litigation model are unsatisfying.<sup>31</sup> But such remarks do not constitute an attack on the thesis of this Commentary, which is that, if the standard model is correct, we should see equal settlement rates under either rule, in the absence of transaction costs. Moreover, as I now demonstrate, this thesis is unshaken by an explicit consideration of three factors: risk aversion, the tendency of litigation costs to rise under the British rule, and the presence of judgment-proof litigants who are unable to pay the fees of opposing prevailing parties.<sup>32</sup>

1. *Risk Aversion.* — It is well settled that the British rule is more risky for litigants because the range of outcomes — both good and bad — is greater for both parties. If things go well for the plaintiff under the British rule, he can costlessly achieve his rightful award, whereas if things go badly, he receives nothing but bills for both his own and the defendant's legal expenses. Under the American rule the need to pay (only) one's own legal fees dampens the joy of victory but moderates the agony of defeat. Similarly, a defendant can walk away from British-rule litigation unscathed if she is successful at trial, but bears a larger burden in the event of defeat at trial than she would bear under the American rule. Risk-averse litigants will see

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depicted in Figure 1 in which the defendant thinks that  $P_d = 0.25$  and the plaintiff believes he has a 90% chance of winning at trial. Under both rules, the parties will go to trial: under the American rule, the plaintiff expects to win B and the defendant expects to pay C; under the British rule, both parties expect to do better (because  $A > B$  and  $D < C$ ). Therefore, the parties would benefit by contracting for trial under the British rule if they happen to be in an American-rule jurisdiction.

In the simple analysis presented thus far, the shifts from one rule to another have always been in one direction: in favor of the British rule. Other outcomes are of course possible if risk aversion is a serious problem or if, as a number of authorities have argued, the British rule leads to significantly larger litigation expenditures. See sources cited *infra* note 35.

<sup>31</sup> See Donohue, *The Effects of Fee Shifting on the Settlement Rate: Theoretical Observations on Costs, Conflicts, and Contingency Fees*, LAW AND CONTEMP. PROBS. (forthcoming 1991).

<sup>32</sup> These three factors all tend to increase the likelihood of settlement under the British rule, thereby potentially narrowing the range of cases in which the likelihood of settlement is greater under the American rule. Of course, if these factors perfectly offset the Posner/Shavell effect, we would expect to see equal settlement rates even absent contractual rule shifts.



the greater riskiness of the British rule as a disadvantage and one that encourages settlement.

My guess is that the effect of the greater riskiness of British-rule litigation is more powerful than some have assumed and that therefore bald claims such as "making the losing party pay the winning party's attorney's fees would reduce, not increase, the settlement rate"<sup>33</sup> are quite likely to be flawed because they fail adequately to acknowledge the force of risk aversion. But risk aversion merely implies that the expected utility from going to trial under the British system is lower than suggested by the preceding analysis, which was based on risk neutrality. Thus settlements would occur under the British rule more often than the Posner/Shavell model indicates. Two conclusions follow: first, risk aversion will tend to diminish the difference between settlement rates under the American rule and the British rule in the static Posner/Shavell model;<sup>34</sup> and, second, the greater similarity in the settlement rates under the two regimes reduces the number of times that parties will be tempted to opt for the British rule. In other words, the Coasean outcome is unchanged by risk aversion: regardless of the legal rule, parties will assess their preferred fee-allocation standard and shift to it if it is not already in place. Risk aversion will increase the proportion of settlements when compared to the case of risk neutrality, but, for any given level of risk aversion, the settlement rate in the absence of transaction costs will be the same under the British and American rules.

2. *Rising Litigation Costs.* — Another objection to the standard Posner/Shavell analysis is that the greater riskiness of the British rule impels parties to invest more resources in litigating claims under that rule.<sup>35</sup> This phenomenon has the identical effect as the introduction of risk aversion. It will induce more settlements under the British rule and make the British rule less attractive to parties in an American-rule jurisdiction. But it will not change the fundamental Coasean invariance prediction. The parties will still assess which rule they prefer and move in that direction if they are not at their preferred rule. The higher litigation costs will change the outcome vis-à-vis a model in which litigation costs are identical under the two regimes, but it will not make the rate of settlement dependent upon whether the litigation is taking place in a British-rule or an American-rule jurisdiction.

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<sup>33</sup> Posner, *Comment on Donohue*, 22 LAW & SOC'Y REV. 927, 928 (1988).

<sup>34</sup> If the effect of the risk aversion were great enough, the settlement rate under the British rule could actually surpass the rate under the American rule. In this event, the analysis in the second paragraph of note 30 above would be altered: in some cases in which settlement is impossible under either rule, the parties would tend to opt to litigate under the American rule rather than to litigate under the British rule.

<sup>35</sup> See Hause, *supra* note 1; Hersch, *Indemnity, Settlement, and Litigation*, 19 J. LEGAL STUD. 235, 235 (1990).

3. *The Existence of Judgment-Proof Parties.* — Some losing parties with meager resources will be unable to bear the costs of any fee award under the British rule. Once again, this will not undermine the Coasean invariance prediction. Instead, the expected benefit to the plaintiff and the expected cost to the defendant under the British rule will be different from the level expressed above. In general, the size of the bribe to settle will be increased — leading to more settlements — because the optimism of the litigants is less likely to be converted into a belief that “someone else will foot the bill.” As we saw in the previous two subsections, however, the parties will still be able to assess whether they are better off with one rule or the other in light of all of the information known to them. Their assessment will not depend on whether they reside in a British-rule or American-rule jurisdiction, and therefore their ultimate choice of which rule to use will be unaffected by the initial legal rule.

### III. IMPLICATIONS FOR THE COASE THEOREM AND LEGAL SCHOLARSHIP

By now the reader should be convinced that, contrary to the assertion that the adoption of the British rule would lead to a fall in the settlement rate, the Posner/Shavell model implies that the settlement rate should be unaffected by the legislatively determined fee-allocation rule as long as the parties are free to adopt, through private contracting, their preferred cost-allocation rule. Simply because the Posner/Shavell economic model, when properly interpreted, implies that the Coasean invariance prediction will apply does not necessarily mean that the world will conform to the theory. Of course, we would expect departures from the invariance prediction because of the presence of positive transaction costs.

In assessing the importance of transaction costs in this context, one should distinguish between two cases: (1) rule shifts that are mutually profitable without the need for side payments, and (2) rule shifts that require bargaining over a side payment because, without such a payment, the rule shift would be Kaldor-Hicks efficient but not Pareto superior.<sup>36</sup> The added negotiation costs that are incurred when side payments are needed will prevent some of the beneficial rule-shifts that fall into the second category from being realized. But it should be noted that the process of agreeing upon the appropriate side payment is identical to the customary task of settling a lawsuit, and therefore the negotiation costs should be roughly of the same

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<sup>36</sup> A Pareto superior outcome would necessarily benefit both parties, whereas a Kaldor-Hicks efficient move would only increase the combined wealth of the parties — perhaps leaving one party worse off because of the distribution of the gain.

magnitude. If the costs are prohibitively large, one might expect never to see agreements that require side payments, but one would also be unlikely to see settlement agreements at all in the typical case in which no rule-shift was contemplated.<sup>37</sup> Because settlement is common, it is unlikely that the costs involved in negotiating a side payment are great enough to inhibit all rule-shifts that require such payments. Transaction costs may keep the zero-transaction-cost invariance prediction from applying, but they are unlikely to explain why there are *no* examples of rule-shifts.

This discussion leads to a very interesting puzzle: in light of the benefits of rule-shifting, why has there *never* been a case in which parties in the course of litigation contracted for a rule different from the one bestowed by the prevailing practice of the jurisdiction?<sup>38</sup> Clearly, transaction costs will often keep parties from always reaching the otherwise optimal fee allocation rule,<sup>39</sup> but it strains credulity to

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<sup>37</sup> Is it less costly to negotiate an agreement when the settlement range is from \$500 to \$1000, than to negotiate a rule-shift that will benefit one party \$600 and harm the other party \$100? In both cases, the span of the settlement range is \$500.

<sup>38</sup> I take this point to be true, although it is of course difficult to prove a negative. I have found no case in the United States or anywhere else in the world that would undermine the authority of this statement, but I would be happy to hear of any examples to the contrary. One additional point: individuals frequently engage in pre-litigation rule-shifting. For example, in California leases it is not uncommon for the landlord to specify that, in the event that suit is brought against the tenant, the tenant must pay the legal fees of the landlord. See *Genis v. Krasne*, 47 Cal. 2d 241, 246, 302 P.2d 289, 292 (1956). Under California law, unilateral efforts to shift fees will in effect be deemed a reciprocal contract to implement the British rule. See *International Indus., Inc. v. Olen*, 21 Cal. 3d 218, 222-23, 577 P.2d 1031, 1033-34, 145 Cal. Rptr. 691, 693-94 (1978); CAL. CIV. CODE § 1717 (West 1985). Thus, if the landlord wins, the tenant pays the fees of both, but if the tenant wins, the landlord will pay the legal fees of both parties. The same law applies in New York. See N.Y. REAL PROP. LAW § 234 (McKinney 1989). This phenomenon, however, does not contradict the statement in the text, which refers only to contractual rule-shifts undertaken during the course of litigation.

<sup>39</sup> There is a considerable array of cases in which the mid-litigation rule-shifts would not likely be attractive. First, opting for the British rule will not be feasible in any litigation based on a statute, such as title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e to 2000e-17 (1988), that in effect provides for one-way rule-shifting in favor of plaintiffs. Second, a plaintiff who seeks to pursue tort litigation under a contingency fee arrangement would probably reject any suggestion of shifting to the British rule if this would make him liable to pay the other side's attorneys' fees in the event of a loss at trial. The whole purpose of the contingency fee is to relieve the plaintiff of the obligation to pay attorneys' fees in the event of a loss at trial.

Another obvious problem standing in the way of easy rule-shifts is the potential divergence of interests between lawyers and clients. First, if clients are aware that the British rule has a tendency to elevate legal fees, they may be suspicious of efforts to shift from the American rule (although clients in British-rule jurisdictions might try to encourage shifts to the American rule). In this event, the client may not want his lawyer to opt for the British rule. Second, lawyers may feel that it is easier to collect fees from their own clients, with whom they have had some relationship, than from the possibly disgruntled opposing party. In this event, the lawyer might not want to opt for the British rule.

Two points should be made in response to the view that the rule-shifts contemplated in this Commentary would be thwarted by principal-agent problems between lawyers and clients. First,

think that transaction costs alone could explain why rule-shifts in the course of litigation are entirely unknown. The answer must lie elsewhere.

### *A. Legal or Ethical Constraints*

Because there is no evidence that anyone has attempted to shift fee-allocation rules during the course of litigation,<sup>40</sup> no cases address the ethical or legal propriety of such behavior. Although no ethical constraint seems to exist, perhaps such a rule-shift would be struck down as contrary to public policy. The American rule represents an implicit legislative judgment that parties in litigation should bear their own legal fees, and perhaps courts will not allow them to overturn this judgment through private contract. Moreover, because the British rule involves an element of a gamble in that fee awards depend on the outcome in the case, the existence of state anti-gambling statutes may buttress the public policy against opting for the British rule.<sup>41</sup>

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pro se litigants would not face such obstacles, which might indicate that such rule-shifts could be found in suits in which neither party was represented by an attorney. On the other hand, the modest assets of most pro se litigants would undermine an opposing party's interest in shifting to the British rule (although this fact might well favor shifts to the American rule if the parties happened to be in a British-rule jurisdiction).

The second point is more subtle. If lawyers feared their clients' response to proposed rule-shifts or disliked the idea of seeking reimbursement from the opposing losing party, they could presumably reach the same expected outcome by using a slightly different technique: the rules of fee allocation would not be changed but the parties would alter the amount in controversy by stipulating to an appropriately calculated but artificial level of damages and then trying the case. In this way, the parties could still reach the same goal of upping the ante that drives the rule-shifting results discussed here without having to confront some of the principal-agent problems associated with rule-shifting. Once again, I am not aware of this ever being done in litigation, but presumably side payments by the parties could make this practice attractive if the Posner/Shavell model is accurate. Here, though, I think that there may be a strong public policy argument against permitting parties in a case from stipulating that the amount in controversy is \$10,000 when the real injury is only \$1000. Such behavior would certainly be deemed a fraud on the court if it were used to circumvent a jurisdictional amount requirement, and might be problematic even when the court would not otherwise be concerned by the true level of damage. See MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 7-26, DR 7-102(A) (1980) (prohibiting a lawyer from using fraudulent or false evidence or testimony).

<sup>40</sup> A litigant who recommends a shift to the British rule would credibly convey his optimism about his own case. This might lead the adversary to revise her own estimate downward, thereby generating a settlement of the case rather than a trial under the British rule. If this effect is powerful, it might indicate why few litigants actually undertake such rule-shifts. Moreover, if the rule-shifts do occur but are never challenged post-trial, the public record might never disclose the practice. It is more likely, though, that if rule-shifts did occur, the losing party would have an incentive to try to wriggle out of the agreement, and therefore challenges would appear in the published cases.

<sup>41</sup> It is unlikely that state anti-gambling statutes would be deemed applicable to any contract to shift to the British rule. For example, the Illinois anti-gambling statute prohibits contracts or games in which "prizes are distributed by chance." ILL. REV. STAT. ch. 38, para. 28-2 (1989). Of course, there is some element of chance in the allocation of fees under the British

There are three reasons why this argument cannot account for the complete absence of cases in which parties in mid-litigation contract for a rule-shift. First, the legal force of the public policy argument is highly tenuous. As noted above,<sup>42</sup> parties frequently contract prior to litigation, with judicial and legislative approval, that disputes arising out of commercial and residential leases, mortgage agreements, and commercial loans will be adjudicated under a British rule.<sup>43</sup> It is unlikely that a court would find such pre-litigation rule-shifting permissible but deem a mid-litigation rule-shift impermissible; the degree of gambling involved in both cases is identical.<sup>44</sup>

Second, to the extent that the public policy argument against rule-shifting rests on an aversion to the gambling component of the British rule, this argument does not explain why there have never been any mid-litigation shifts from the British rule to the American rule. Such shifts would eliminate the gambling dimension, because both parties would be responsible for their own legal fees regardless of the case's outcome.<sup>45</sup> As a general matter, explanations of why shifts from the

rule, just as there is in the case of a contingency fee between a plaintiff and his attorney. As the official comment accompanying the New York gambling statute states: "The test of the character of the game is not whether it contains an element of chance or an element of skill, but which is the dominating element that determines the result of the game?" Donnino, *Practice Commentaries*, N.Y. PENAL LAW § 225, at 103 (McKinney 1989) (quoting *People ex rel. Ellison v. Lavin*, 179 N.Y. 164, 170, 71 N.E. 753, 755 (1904)). It requires a rather high degree of cynicism to believe that the outcome of trials are primarily chance events.

One can still run afoul of the anti-gambling statute if two strangers to a contest to be determined primarily by skill place a wager on the outcome, because gambling embraces "not only a person who wagers or stakes something upon a game of chance but also one who wagers on 'a future contingent event [whether involving chance or skill] not under his control or influence.'" *Id.* at 104. But, of course, the parties in litigation are not strangers to the contest. Just as contingency fees and business ventures will not run afoul of the anti-gambling provisions, see *Wells v. J.C. Penney Co.*, 250 F.2d 221, 231-35 (9th Cir. 1957); *Liss v. Manuel*, 58 Misc.2d 614, 617-18, 296 N.Y.S.2d 627, 631-32 (Civ. Ct. 1968), neither would the rule-shifting contract contemplated in this Commentary, despite the element of risk and the lack of complete control over the outcome.

<sup>42</sup> See *supra* note 38.

<sup>43</sup> See, e.g., *Federal Land Bank of Springfield v. Ambrosano*, 89 A.D.2d 730, 731, 453 N.Y.S.2d 857, 858 (1982) (awarding attorneys' fees pursuant to terms of a mortgage agreement).

<sup>44</sup> One possible distinction that would favor the legality of pre-litigation fee-shifting agreements is that the contractual provision is designed to induce the parties to adhere to the terms of the contract. On this view, one might permit pre-litigation rule-shifts because they influence the primary behavior of the contracting parties, but regard mid-litigation rule-shifts as mere gambles. Moreover, such mid-litigation rule-shifts may be socially inefficient if they cause cases to be tried that could otherwise settle. See *supra* note 20. But even mid-litigation rule-shifts serve the valid function of penalizing litigants who are overly optimistic about their chances of success. Because at the very least such over-optimism can inappropriately skew the resolution of a dispute in favor of the excessively optimistic party, there is social value in sanctioning such litigants.

<sup>45</sup> I employ the economist's definition of a "gamble" as an event that elevates the risk to one or both contracting parties. Because the range of possible outcomes is greater under the British

American rule to the British rule have not been attempted are inadequate if they do not simultaneously explain why the reverse shifts have not occurred.<sup>46</sup>

Third, it is unlikely that doubts about the enforceability of a contract on this basis would be sufficiently compelling to stop all experimentation in rule-shifting. When parties perceive possible profit opportunities, they have an incentive to test the limits of any potential legal impediment.<sup>47</sup> Even when these apparent legal barriers are quite strong, the profitable activity will often be undertaken, thereby generating litigation.<sup>48</sup> Indeed, the objection on public policy grounds seems so subtle that it might even be overlooked by the parties. Accordingly, the public policy argument seems too fragile an obstacle to have prevented every rule-shift.

### *B. The American Rule Is Optimal*

Perhaps there have been no rule-shift cases because everyone finds the American rule to be optimal. This might be the case if the degree of litigants' risk aversion is quite high. However, this reasoning does not explain why, if parties are risk averse and thus prefer the American rule, there are no shifts away from the British rule.<sup>49</sup> Strategic factors might encourage litigants to avoid behavior that might reveal a low estimate of one's own likelihood of success. But this factor

rule — both parties can win (or lose) more than under the American rule — the variance of returns, or "risk," is greater under the British rule.

<sup>46</sup> Indeed, the three factors discussed above, *see supra* pp. 1107-09 — risk aversion, higher litigation costs under the British rule, and the existence of judgment-proof parties — would all make the American rule more attractive. Yet there is no evidence that litigants in British-rule jurisdictions ever shift to the American rule.

<sup>47</sup> Although a one-time litigant might not have an incentive to incur the litigation costs of testing the legality of rule-shifting, insurance companies and other firms that are heavily engaged in litigation would presumably view these costs as trivial when apportioned across all of the cases in which the strategy might be employed.

<sup>48</sup> One such example is the aforementioned insertion into many contracts of a one-way fee-shifting rule in which the draftsman is the beneficiary. *See supra* note 38. Such one-way fee-shifts seem more problematic than bilateral agreements to opt for the British rule because the contractual language only protects one party, and the other party might not even be aware of the contractual provision. Another example of a questionable practice that generates much litigation is the so-called "Mary Carter" agreement. *See infra* note 53.

<sup>49</sup> One would have to have a strong belief in the perfect matching of laws and electorates to contend that Americans find the American rule optimal and that almost everyone else finds the British rule optimal. A number of factors would influence whether rule-shifts in favor of the American rule would be possible in British-rule jurisdictions. One might argue that the public policy in favor of fee-shifting is more clearly asserted in British-rule jurisdictions than is the opposing public policy in America. This factor would cut against opting for the American rule. On the other hand, as noted above, the public policy argument against rule-shifting because of an ostensible gambling element is weakened when the parties are opting for the American rule. Moreover, it may well be easier to relinquish rather than to assert a claim for attorneys' fees, thereby facilitating shifts to the American rule.

would encourage parties to recommend the shift to the British rule in order to convey information that they are optimistic about their case.

### *C. The Failure to Maximize Wealth or Welfare*

This Commentary has argued that, if the Posner/Shavell model of the settlement decision is correct, litigants will expect to profit in certain cases by opting for their preferred rule of fee allocation. But the parties cannot act to circumvent the legislative rule unless they realize that this is a profitable possibility. Because no other theory explains the complete absence of mid-litigation rule-shifting, the best explanation may be that no litigant has ever recognized this contractual opportunity.<sup>50</sup>

But this conclusion rips at the heart of one of the core beliefs of the Chicago school — that profitable opportunities are never left unexploited for more than the shortest time frames. If the Posner/Shavell framework is a sound model for analyzing the decision to settle or try a case, the belief that “what is, is optimal” simply collapses. “What is” may be the best that can be done given the current state of knowledge, but only because profitable opportunities are being widely overlooked.<sup>51</sup> But this means that Coasean outcomes might not be achieved even when transaction costs do not stand as a barrier and that unprofitable practices might persist for years, decades, perhaps centuries, without being driven from the marketplace.<sup>52</sup>

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<sup>50</sup> Another possible explanation of the absence of rule-shifts is that my modeling of the failure to settle based on disagreements of the parties concerning the probability of success is incorrect. If parties always agreed on the likelihood of success, trials could still occur whenever the parties disagreed on the expected level of damages that would be generated by a verdict for the plaintiff. But if parties always agreed on the likelihood of success, there would be no perceived surplus generated by shifting to the British rule.

<sup>51</sup> This issue is related to my debate with Judge Posner over the desirability of the passage of title VII of the 1964 Civil Rights Act. See Donohue, *Is Title VII Efficient?*, 134 U. PA. L. REV. 1411 (1986); Posner, *The Efficiency and Efficacy of Title VII*, 136 U. PA. L. REV. 513 (1987); Donohue, *Further Thoughts on Employment Discrimination Legislation*, 136 U. PA. L. REV. 523 (1987). I argued that the historical record is inconsistent with the view that the market eliminates discriminators at the optimal rate, and therefore the antidiscrimination law may have served to enhance economic efficiency. In response, Judge Posner argued that Southern employers hired blacks whenever it was profitable to do so and that I ignored adjustment costs incurred in driving out discriminators more quickly than the market acting alone could do. But if profitable opportunities can be overlooked, the strong a priori position against government antidiscrimination law is undermined. The idea of hiring blacks for certain jobs may have been as elusive to many Southern employers in 1950 as the idea of bargaining to change the fee-allocation rule has been for many litigants.

<sup>52</sup> Of course, one could always resurrect the validity of a Coasean prediction by asserting that ignorance of a possible beneficial action represents a transaction cost that inhibits its attainment. But it may be useful to distinguish the following two cases. First, assume that X is the outcome that would occur if transaction costs were zero, and Y is the outcome that exists because transaction costs are in fact positive. In this situation, Y would be the optimal outcome and any attempt to impose solution X would be wasteful socially. Second, assume that X is

How could this be? One might think that one litigant somewhere must have thought of the possibility of rule-shifting if it is indeed a potentially profitable strategy.<sup>53</sup> Furthermore, if individuals and firms are truly utility and profit maximizers, they must take steps in pursuit of their best interests. Perhaps, however, the answer to these assertions is that they disregard the distinction between maximizing one's welfare (or wealth) while accepting one's environment as given and maximizing welfare when this requires altering one's environment.<sup>54</sup> The human mind finds it far easier to make the best out of the current state of the world than it does trying to conceive all of the ways in which the state of the world itself can be altered. Indeed, this distinction is analogous to the point that Coase deemed most significant in his 1960 article: one cannot consider only marginal changes and hope to maximize welfare; one must compare the total welfare under differing social or legal arrangements.<sup>55</sup> Both Posner and Shavell, along with their supporters and critics, have focused on the marginal analysis and overlooked the crucial comparison between welfare under the two different — and always available — regimes.

the outcome that would occur if the actors understood all relevant information about X, and Y is the outcome that prevails in their ignorance. Under such circumstances, the governmental imposition of solution X may be welfare enhancing. In this sense, ignorance is not a true transaction cost.

<sup>53</sup> Indeed, litigators have shown remarkable creativity in structuring their lawsuits in certain settings. A good example is the "Mary Carter" agreement, in which the plaintiff and one defendant agree that this settling defendant will remain in the case but will team up with the plaintiff against another defendant. The array of these innovative agreements is breathtaking. For example, in *General Motors Corp. v. Lohocki*, 286 Md. 714, 410 A.2d 1039 (1980), the settling defendant agreed to pay the plaintiff \$150,000 unless any of the following events occurred: (1) if the judgment against the settling defendant was greater than \$150,000, it would pay the plaintiff that amount but with a cap of \$250,000; (2) if judgment was entered against only the other defendant, General Motors, the settling defendant would pay nothing; and (3) if General Motors settled with the plaintiff, the settling defendant would pay \$100,000 to the plaintiff. See *id.* at 719 n.1, 410 A.2d at 1042 n.1. In another case, the settling defendant would recover 50% of the first \$886,621 of any judgment against the non-settling defendant. See *National Union Fire Ins. Co. v. Allison*, 698 S.W.2d 198, 200 (Tex. Ct. App. 1985). While the legality of such agreements has been questioned by certain commentators and courts, they are becoming increasingly common. Compare Note, *Gallagher Covenants, Mary Carter Agreements, and Loan Receipt Agreements: Unsettling Contributions to Conflict Resolution*, 1977 ARIZ. ST. L.J. 117 (criticizing such agreements) with Note, *It's a Mistake to Tolerate the Mary Carter Agreement*, 87 COLUM. L. REV. 368 (1987) (arguing that such agreements can be useful if not abused).

<sup>54</sup> A mathematical analogy may be instructive. It is far easier to find the maximum value of a function using basic calculus than it is to find the optimal function itself, which requires the more sophisticated calculus of variations. Similarly, it may be easier for economists to think in terms of maximizing continuous functions, for which the handy tool of calculus is available, than to evaluate discontinuous shifts in choice variables.

<sup>55</sup> In Coase's words: "In devising and choosing between social arrangements we should have regard for the total effect. This, above all, is the change in approach which I am advocating." Coase, *supra* note 4, at 44.



The very fact that the rule-shifting option eluded Posner, Shavell, and all the other law and economics scholars working in this field buttresses the claim that a profitable opportunity has indeed been overlooked by litigants. Of course, the supporters of Dr. Pangloss might rush to explain that Posner and Shavell would have nothing to gain from spotting the applicability of the Coasean invariance prediction, whereas litigants and other market participants have real money at stake, making it impossible for them to overlook profitable opportunities for long. Therefore, they would argue, the fact that academics have missed the point cannot lend credence to the view that litigants have overlooked this contracting strategy (instead of merely rejecting it as involving overly high transaction costs or because of its incompatibility with public policy). Although there may be some force to this argument, we should explore it more carefully because, in essence, it implies that there is little incentive for legal academics to analyze issues correctly. This also may be true, but it is a serious charge.

Judge Posner has commented on the Popperian conception of the scientific method: "The big thing is to come up with hypotheses that have a sufficiently low antecedent probability of being true to be interesting, but that are not so ridiculous that the results of testing them empirically are a foregone conclusion, and to get on with the testing of them."<sup>56</sup> Because, on the whole, legal scholars do very little testing, the central task in the legal academy may be merely to come up with interesting hypotheses that have a sufficiently low probability of being true. The Posner/Shavell assessment on the inhibiting effect of the British rule on the rate of settlement is counterintuitive — indeed contrary to Posner's initial view based on risk aversion — but it would seem no more counterintuitive than the invariance prediction discussed here. On the other hand, the Posner/Shavell model is counterintuitive in a new way, whereas the invariance point is counterintuitive in a way that has already brought celebrity to Ronald Coase. Therefore, the extreme Panglossean view might be that it was in Posner's and Shavell's self-interest to overlook the Coase theorem. Nonetheless, the parade of scholars who continued the analysis of the British rule might have profited by heralding the Coasean insight. But none did.

Is it possible, then, that we have never heard of a single case of contracting around the fee-allocation rule because the parties never thought of it, and that we have never read about the idea in the legal or economic literature because no one — regardless of how familiar with the Coase theorem — has ever conceived of the idea?<sup>57</sup> At one

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<sup>56</sup> Posner, *The Future of Law and Economics*, 65 CHI.-KENT L. REV. 57, 61 (1989).

<sup>57</sup> I asked 29 students in my Law and Economics class at Northwestern to write papers showing how the application of the Coase theorem would lead to identical settlements under either the British rule or the American rule. Not one mentioned the rule-shifting option.

level, both lapses may be somewhat surprising. After all, we needed just one litigant to realize that opting for the British rule would make sense, and if it were a good idea, it would quickly catch on.<sup>58</sup> It is also surprising in the academic setting, because the individuals who have neglected the point are clearly those who are most knowledgeable about the Coase theorem and therefore least likely to overlook its dictates.<sup>59</sup> If renowned law and economics scholars can overlook the Coase theorem in publishing repeated articles on a theme that cries out for Coasean treatment, what hope is there that some harried litigant will perceive the opportunity?<sup>60</sup>

The lapse among litigants should give Coaseans pause in suspecting that parties will always perceive Coasean bargaining opportunities,<sup>61</sup> particularly those that require reshaping the legal structure of

<sup>58</sup> It is useful to distinguish between what the "market" knows and what any one individual knows. In many settings, as soon as someone thinks of a new and more profitable way of doing things, others will follow suit fairly quickly. Although this Commentary has given many examples of situations in which opting for the British rule would not make sense — for a plaintiff suing under a contingency fee, when the parties are disputing damages but not the likelihood of success at trial, when wealth effects associated with the shift require an additional negotiation of a side payment and such negotiation costs are greater than the expected benefits from the rule-shift, etc. — it surely must be the case that the rule-shifting strategy would have been profitable for some litigants. If, however, shifting the fee-allocation rule is generally not profitable, those litigants for whom it would be profitable will be likely to have to think of it themselves. In this event, because it is much easier to copy than to conceive, we would expect at most only isolated use of the rule-shifting option even if some individuals did occasionally think of it and adopt it. Alternatively, if the rule-shifting option were widely profitable, it would probably only take a few instances of its use before it was broadly implemented. Because rule-shifting clearly has not been broadly implemented, it is probably fair to assume that rule-shifting is either not widely profitable or has never been conceived.

These considerations also suggest that there is a greater likelihood that Coasean bargains will be perceived and struck, if individuals can observe others engaging in such transactions and simply copy them than if they must conceive of the idea of the bargain independently. This fact may serve to reconcile the experimental findings in which Coasean outcomes are achieved — see the articles cited in Donohue, *Diverting the Coasean River: Incentive Schemes to Reduce Unemployment Spells*, 99 YALE L.J. 549, 552 n.8 (1989), where the parties are informed of their bargaining options — with the empirical data showing the failure of Coasean identity predictions — as in the one-shot Illinois experiment discussed below in note 61.

<sup>59</sup> A party that opts for trial under the British rule in lieu of settlement under the American rule may be engaging in behavior that is privately efficient but socially inefficient. See *supra* note 20. Perhaps this explains why law and economics scholars might overlook the rule-shifting option: they are trained to seek solutions that enhance social welfare. Moreover, while there is no social welfare loss when parties opt to try a case under the British rule that would be tried in any event under the American rule, neither is there any welfare gain. See *supra* note 30.

<sup>60</sup> Of course, it is not just the litigants who may have failed to perceive the rule-shifting option but their attorneys as well. If anything, though, the likelihood that attorneys' fees would grow under a British rule would seem to suggest that attorneys would have an incentive to recognize the British rule option. Conceivably, however, attorneys might believe that it is easier to collect legal fees from one's own client than from the opposing (losing) party.

<sup>61</sup> I have made this point in the past, see Donohue, *supra* note 58, at 601-02, once leading to the accusation that I had a low estimate of human intelligence, see Ellickson, *The Case for*

the world that confronts us. That Posner and Shavell could overlook such an opportunity dramatically confirms that exceptional intelligence and thorough familiarity with the Coase theorem cannot guarantee that Coasean bargains will be perceived and struck. Consequently, we should be cautious in asserting that Coasean invariance predictions will universally be achieved — even without giving any consideration to transaction costs.<sup>62</sup>

Indeed, this caution is particularly appropriate in light of the fact that American litigants might be expected under Coasean logic to opt for a fee-shifting rule even if no model of fee-shifting were available to inform their enterprise of wealth maximization. But there *is* such a model. Almost every country in the world except the United States has adopted some form of the British rule. The comparative evidence cries out for litigants in America to see what much of the rest of the world seems to know — that the British rule has some considerable advantages.<sup>63</sup> But even with this tip, the message has not been heard. A very important lesson may emerge from this discussion: if *all* profitable steps of equal opacity could suddenly be recognized, the gross national product could be vastly higher than it is today.<sup>64</sup>

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*Coase and Against "Coaseanism,"* 99 YALE L.J. 611, 624–25 (1989). My point was that, unless unemployment recipients realized that they could capture through negotiation some or all of any bonus paid by Illinois to employers who hired workers off the unemployment compensation rolls, the identity prediction of the Coase theorem would not be attained. I am dubious that virtually all workers would perceive this, especially because the economists who devised the Illinois experiment did not perceive it themselves. See Donohue, *supra* note 58, at 575 n.67. Unless one happens to be focusing directly on the Coase theorem, it is often very difficult to perceive advantageous Coasean bargaining opportunities.

<sup>62</sup> This theme was initially explored at some length in Farber, *The Case Against Brilliance*, 70 MINN. L. REV. 917, 919–20 (1986). See also Donohue, *supra* note 58, at 601 n.121 (considering Farber's claim that most people will not realize the implications of the Coase theorem as a possible explanation for the results of the Illinois unemployment experiment).

<sup>63</sup> Indeed, one of the strongest assertions to this effect is found in an early survey article by Judge Posner in which he wrote: "the failure to require that the losing party to a lawsuit reimburse the winner for his litigation expenses appears to be highly inefficient, and no economic explanation for this settled feature of American procedure has been suggested or is apparent." Posner, *The Economic Approach to Law*, 53 TEX. L. REV. 757, 765 (1978).

<sup>64</sup> A famous psychological experiment may explain both why so many profitable ideas are not perceived and why I happened to recognize the rule-shifting option for litigants. See Maier, *Reasoning in Humans, II*, 12 J. COMP. PSYCHOLOGY 181 (1931). Subjects were told to tie two strings together that were hanging from the ceiling. The problem was that the strings were far enough apart that one could not hold one and reach the other. Virtually everyone failed the endeavor. Then the experimenter exposed another group of individuals to the same problem, but this time he brushed against one of the strings, setting it swinging. Almost everyone quickly realized that by tying something to one of the strings, one could swing that string toward the other, enabling both strings to be tied. Because I approached this problem purely from the perspective of the Coase theorem, in effect I had the hint of the swinging string to aid in my analysis of the problem. I would imagine that business managers, scientists, academics, and indeed all individuals confront "dangling strings" each day that they just do not see how to tie, even though, with the slightest assistance, the solution to the problem might become quite

## IV. CONCLUSION

One of the great advantages of the Posner/Shavell litigation model is that it captures rather simply the basic process of deciding whether to settle or try a case and provides concrete predictions about the likelihood of settlement under the British and American rules for allocating litigation costs. But if the model is useful, it is important to note that the Posner/Shavell conclusion — that a shift to the British rule would lower the rate of settlement — is theoretically incorrect. A correct application of the Coase theorem to their model would reveal that the parties should make the same decisions regarding settlement whether they live in a jurisdiction that adheres to the British rule or one that follows the American rule. As the Coase theorem would suggest, the litigants can simply choose the fee-allocation rule that generates greater total expected wealth, and this choice will be unaffected by the legal standard.

The failure to discover any instance in which parties have altered the fee-allocation rule is puzzling. One possible explanation is that the Posner/Shavell model is not useful for analyzing the decision to settle or litigate. A second possibility is that the transaction costs in rule-shifting are too high to make this a profitable strategy. The failure of the law and economics literature to spot the Coasean solution may suggest that the incentives to be accurate in the academic literature are weak and ineffectual. But an alternative answer has nothing to do with incentives or transaction costs: maximizing wealth is difficult enough when one is able to hold constant all but a few variables; it verges on impossible when one must also select, through contract, the optimal levels of all conceivable variables. Unless, like me, one happens to be focused directly on the Coase theorem and devotes an inordinate amount of time to unraveling its implications in the context of the “litigate or settle” question, one is unlikely to pick the rule-shifting strategy out of the haystack of regime changes. Rather than focus on transaction costs as the last refuge for those struggling to preserve the empirical validity of the Coase theorem, we should probably just try to remember the Coase theorem in the first place.

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obvious. Moreover, the fact that it is hard to enumerate all such profitable opportunities waiting to be perceived does not mean that they are not abundant (perhaps they are more abundant than perceived opportunities). For example, as Cantor has shown, there are infinitely more irrational numbers than rational numbers, but most individuals can think of no more than a few irrational numbers while the rational numbers are obviously infinitely abundant. *See* J. DAUBEN, *GEORG CANTOR: HIS MATHEMATICS AND PHILOSOPHY OF THE INFINITE* 64–69 (1979).