Endogenous Fee-shifting

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1 Introduction

In a civil trial the judge typically takes two decisions: he adjudicates the case and decides who pays the litigation costs. While the literature has studied the litigation process under different fee-shifting rules, the role of the judge has not been examined. Existing literature focuses on exogenous fee-shifting rules that determine ex ante who pays the litigation costs. For instance, under the American rule each party pays own litigation costs, while under the English rule the losing party pays both parties' litigation costs.

We endogenize the determination of the fee-shifting arrangement by giving the judge a choice how to allocate the litigation cost. In the model, the judge decides based both on the outcome of the case (who wins) and on the quality of the information he receives from the party (how sure the judge is about who should win). Therefore, two cases might be adjudicated in the same way but yield a different allocation of the litigation costs.

We model two parties with common information about the merit of the case but bilateral asymmetric information about the evidence each of them has. Parties first try to reach a settlement agreement and, if they fail, go to trial. Bargaining during the settlement phase is modeled as a one-shot simultaneous-bid process, where each of the parties submits a bid and if the plaintiff's request is lower than the defendant's offer, they settle for an amount between demand and offer. Otherwise they litigate.

If they go to trial, the judge will adjudicate the case based on the evidence the parties submit. Based on the same evidence, the judge will decide how to allocate the litigation costs. The parties anticipate the judge's decision and adjust their bids accordingly, also depending on their evidence.

Operationally, we vary a parameter that determines the way in which the judge decides to allocate the litigation costs. Thereby, we consider a range of endogenous fee-shifting rules, including the American rule and the English rule as limit cases. We study how the way in which the judge allocates the litigation costs affects the parties' decision to go to trial rather than settling the case and as a result the characteristics of cases before the court.

2 Model

We consider two parties of a legal dispute: a plaintiff and a defendant. The plaintiff seeks compensation from the defendant. For instance, the plaintiff could be a pedestrian who has been the victim of a traffic accident, and the defendant is the car driver responsible for the accident. Likewise, the plaintiff could be the promisee in a contract while the defendant is the promisor. The amount of the compensation is normalized to 1 without loss of generality.

Both parties know that, given the law and the facts of the case, the plaintiff has the right to collect $q \in (0,1)$ from the defendant. In a sense, the merits of the case are clear to the parties. However, the judge cannot observe q and hence will adjudicate the case only based on the evidence that the parties are able to present. Each party holds a piece of evidence which is unknown to the other party: there is bilateral asymmetric information. Crucially, a party's private information cannot be credibly conveyed to the other prior to the trial. For instance, the content of plaintiff's witness testimony will only be clear at trial, while prior to the trial it will be difficult for the defendant to verify what kind of information the witness actually has.

Going to trial imposes a cost c to each party and hence would be in the interest of the parties to settle the case out of court. However, the fact that each of them holds private information makes them behave strategically and hence fail to settle some or all of the cases. We model evidence as uniformly distributed private signals $\theta_\pi \in [0,q]$ and $\theta_\delta \in [q,1]$ for the plaintiff and the defendant, respectively. Consequently, the judge will adjudicate the case according to $J = \frac{\theta_\pi + \theta_\delta}{2}$, where J is the amount of money that the plaintiff will be able to collect from the defendant. Note that, depending on the evidence that the parties have, the judgment J will be typically different from the true merits of the case q.

Next to adjudicating the case, the court will have to decide who pays the litigation fee. Under the prevalent rule in the United States (the "American Rule") each party bears his own litigation costs. Instead, under the "English Rule", the loser pays all costs. We consider here a more general setting that embeds these two extreme rules as special cases. In fact, in most countries, the court has some discretion while deciding on the allocation of the litigation cost, based on the evidence presented by the parties. We introduce the following allocation rule:

$$\alpha\left(\theta_\Delta, \theta_\Pi\right) = \begin{cases} 0 & \text{if} \quad \theta_\Delta \leq t \quad \& \quad \theta_\Delta \leq 1 - \theta_\Pi \\ \frac{1}{2} & \text{if} \quad \theta_\Delta > t \quad \& \quad \theta_\Pi \leq 1 - t \\ 1 & \text{if} \quad \theta_\Pi > 1 - t \quad \& \quad \theta_\Delta > 1 - \theta_\Pi \end{cases}$$

where $t \in [0,1]$ is our fee-shifting parameter, which determines the type of rule that the court uses, and α is the portion of the total litigation costs that the defendant pays. To keep the analysis simple, we simply allow for three cases: the defendant pays all costs, each party pays his own costs, or the plaintiff pays all costs.

This simple fee-shifting rule has appealing properties:

- The rule is symmetric in the sense that if the plaintiff's evidence were as strong as the defendant evidence is (and vice versa), the plaintiff would pay the defendant's share (and vice versa): $\alpha(\theta_\Pi, \theta_\Delta) = 1-\alpha((1-\theta_\Delta), (1-\theta_\Pi))$;
- The share of the litigation costs that a parties pays decreases in his "merit", that is, the plaintiff pays less if $\theta_\pi + \theta_\delta$ is larger;
- The share of the litigation costs that a party pays is more likely to be $\frac{1}{2}$ if the "precision" of the evidence is less, that is, if $\theta_\pi - \theta_\delta$ increases.

The parameter t determines the rule that the court applies depending on the weight that evidence has in shifting the litigation costs. If $t = 0$ we have the American Rule where $\alpha = \frac{1}{2}$ (merit has no weight), while if $t = 1$we have the English Rule α is either 0 or 1, depending on whether J is greater or less than $\frac{1}{2}$ (merit has full weight irrespective of precision). Intermediate values implement a range of different fee-shifting rules that balance merit and precision in different degrees.

3 Settlement versus trial

To model settlement we use the following bargaining mechanism also used by Friedman and Wittman (2006) each party simultaneously submits a bid, if the plaintiff's bid (the minimum that he is willing to accept) is less than the defendant's bid (the maximum that he is willing to pay), then the parties settle for an average of the two bids; otherwise, they go to court and the judge will adjudicate the case and allocate the litigation costs depending on the evidence they produce.

This bargaining process has the advantage of preserving symmetry as we do not have to make assumptions on who makes a take it or leave it offer to the other, as it is commonly done in signaling and screening models used to examine settlement.

Typically, the parties do no reveal their signals truthfully, that is, their bids are not equal to their signals. To see why truthful revelation is not an equilibrium consider that the plaintiff can try to increase his bid and hence risk to go to court slightly more often while improving the amount he receives in all cases in which he settles. Hence marginally increases the bid above the value of the signal is in general profitable. The defendant will do the same and the parties will end up in court with a positive probability that depends on the litigation costs and on the shifting rule.

4 Analysis

To keep the analysis tractable, we focus on linear bid functions. We derive the equilibrium linear bid functions of the two parties by maximizing their expected payoff from settlement and trial given their bids.

The analysis yields several cases that depend on the values of q and t and that we analyze separately. In each case we derive different bid functions. Based on the bid functions, we derive equilibrium probabilities of settlement and trial, which depend on q, t and c. By setting the parameter t the court can affect the amount of litigation. In addition, the parties tend to litigate different cases with different probabilities depending on t. Therefore, by setting t, the court can affect the type of cases that go to trial; for instance, the court could see more extreme cases (q different from $\frac{1}{2}$) or more balanced cases (q close to $\frac{1}{2}$) at different values of t. Finally, we derive empirical and policy implication of our analysis.

References

[1] Friedman, D., & Wittman, D. (2006). Litigation with Symmetric Bargaining and Two-Sided Incomplete Information. *Journal of Law, Economics, and Organization*, 23(1), 98–126.