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ON SETTLEMENT TERMS

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Abstract

The large economic literature on fee-shifting rules has focussed on the effects that they have on the likelihood of settlement and the incentive to sue. In contrast, this paper focusses on the rules' effect on the terms of settlement. The analysis demonstrates that fee-shifting rules influence the terms of settlement, and it further identifies the effect of each of the main fee-shifting rules on settlement terms. For each such rule, the analysis examines whether the rule will make settlement terms more favorable to the plaintiff or the defendant -- and also whether the rule will move these terms closer to or further away from the expected judgment.

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I. INTRODUCTION

Litigation is costly both to the parties involved and to the judicial system. From the point of view of a plaintiff or a defendant, however, the cost of litigation is heavily dependant on the fee-shifting rule that is in place. Under the “American rule,” which is the normal method for allocating fees in the United States, each party bears its own litigation costs, regardless of the outcome of the case. Under the “British rule,” however, the losing party must pay both her own costs as well as those of the winning party. Under the pro-plaintiff rule to be examined in this paper, the plaintiff gets its fees reimbursed if it wins but there is no fee shifting if the defendant wins.¹ Finally, under the pro-defendant rule, the defendant gets its fees reimbursed if it wins but there is no fee shifting if the plaintiff wins.

The law and economics literature on litigation and settlement has already devoted much attention to the effects of fee-shifting rules. The literature has analyzed the effect of fee-shifting rules on the likelihood of settlement,² the incentive to sue,³ and litigation costs.⁴ The literature, however, has largely ignored the question of whether such rules

¹Pro-plaintiff fee-shifting is used in the United States for a few types of cases. For example, cases under Title VII of the 1964 Civil Rights Act are subject to the pro-plaintiff rule. See *Newman v. Piggie Park Enter, Inc.*, 390 U.S. 412 (1978).

²See, e.g., Lucian A. Bebchuk, *Litigation and Settlement under Imperfect Information*, 15 RAND J. ECON. 404 (1984).

³See, e.g., Steven M. Shavell, *The Social versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEG. STUD. 333 (1982); Lucian A. Bebchuk & Howard Chang, *An Analysis of Fee-Shifting Based on the Margin of Victory: On Frivolous Suits, Meritorious Suits, and the Role of Rule 11*, 25 J. LEG. STUD. 371 (1996).

⁴See, e.g., Avery Katz, *Measuring the Demand for Litigation: Is the English Rule Really Cheaper?* 3 J. L. ECON. & ORG. 143-76 (1987).

affect the terms of settlement.

The potential effects of fee-shifting arrangements on settlement terms is important because the vast majority of cases end with a settlement rather than a judgment. Only a small fraction of legal disputes are ever actually filed,⁵ and it is estimated that no more than five percent of all cases filed reach trial.⁶ These facts demonstrate that the law affects the outcome of disputes principally through its effect on settlements negotiated “in the shadow of the law,”⁷ rather than through actual judgments.

The analysis presented below demonstrates that fee-shifting rules do indeed have a substantial effect on the terms of settlement. The paper develops a model which examines the effect of fee-shifting from two perspectives. First, the analysis considers whether a given rule makes the terms of settlement more favorable to the plaintiff or the defendant. When the answer to this inquiry depends on other variables, the model identifies what those are.

⁵See Kathy Spier, *The Dynamics of Pretrial Negotiation*, 59 REV. ECON. STUD. 93; D. Trubek, et al., *The Costs of Ordinary Litigation*, 31 U.C.L.A. L. REV. 72 (1984) (estimating that 90% of civil disputes are settled without filing a claim). See also G.R. WILLIAMS, LEGAL NEGOTIATION AND SETTLEMENT (1983).

⁶See D. Trubek et al., *The Cost of Ordinary Litigation*, 31 U.C.L.A. L. REV. 72 (1983); H. LAWRENCE ROBS, SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENTS 136 (stating that less than 5% of bodily injury claims reach trial) (1980); ANNUAL REPORT OF THE DIRECTOR, ADMINISTRATIVE OFFICER OF THE UNITED STATES COURTS, 1987 REPORTS OF THE PROCEEDINGS OF THE JUDICIAL CONFERENCE OF THE UNITED STATES 211 (various years) (showing in Table C-4 that the percentage of all federal cases reaching trial was 5% in 1984, 4.9% in 1987, and 3.5% in 1992). For a historical summary of the years 1940 - 1980, see Marc Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (And Think We Know) About our Allegedly Contentious and Litigious Society*, 31 U.C.L.A. L. REV. 4, 44 (1984).

⁷Robert Cooter, Stephen Marks & Robert H. Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEG. STUD. 224 (1982).

Second, the analysis demonstrates whether each fee-shifting rule moves the settlement closer to or further from the expected judgment, as compared to the American rule.

The paper is organized as follows. Section II presents the framework that will be used to analyze the effect of fee-shifting rules on settlement. Section III examines the bargaining between the parties and will develop a basic result that will be useful in analyzing the expected settlement under any given fee-shifting rule. Section IV analyzes the British rule and Section V considers the pro-plaintiff and pro-defendant rules. Section VI offers some concluding comments.

II. FRAMEWORK OF ANALYSIS

Consider a plaintiff, P , who has a potential suit against a defendant, D . If the suit proceeds all the way to judgment, the plaintiff will win with probability π . Conditional on the plaintiff winning, the expected award is J . The expected judgment, therefore, is πJ .

The litigation process involves costs. The total costs of the litigation that will be incurred by the plaintiff and the defendant are, respectively, C_p and C_d .

How the total costs ($C_p + C_d$) are ultimately divided between the parties depends on the prevailing rules of cost allocation -- the fee-shifting rules. The probability that the plaintiff will get his fees reimbursed by the defendant will be labeled P_p , and the probability that the defendant will have her fees reimbursed by the plaintiff will be labeled P_d . As will be discussed in more detail below, P_p and P_d are, of course, functions of the prevailing legal rules of cost allocation.

In order to keep the model simple, we will focus only on cases in which the plaintiff's

suit has a positive expected value. In such cases, there is no question that the plaintiff has a credible threat to litigate.⁸

The bargaining process will be modeled as follows.⁹ It is assumed that the parties can bargain over settlement not only before any litigation costs are incurred, but also at various points during the litigation process. Specifically, there will be n stages between the filing of a suit and the judgment. During each stage, each party incurs a fraction of its total litigation costs. Let c_p^i and c_d^i represent the costs incurred in stage i by the plaintiff and the defendant, respectively.¹⁰

Because parties' costs are spread over various stages, bargaining can always take place after some, but not all litigation costs have been incurred. Specifically, it is assumed that the parties may bargain prior to each of the N stages in which costs will be incurred. During any given bargaining round, if that round is reached, either the plaintiff or the defendant will make a settlement offer. The identity of the party that can make the settlement offer in any given round is assumed to be determined randomly just prior to that

⁸For an analysis of the credibility issues arising in the case of negative expected value suits, see Lucian A. Bebchuk, *A New Theory Concerning the Credibility and Success of Threats to Sue*, 25 J. LEG. STUD. 1 (1996); Lucian A. Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEG. STUD. 437 (1988).

⁹The general set-up used to analyze the bargaining between the parties is similar to that used in Bebchuk, *supra* note 8.

¹⁰We will pay especially close attention to the case in which the process is very finely divisible. That is, the case in which bargaining can take place on numerous occasions during the litigation process so that for all i , c_p^i and c_d^i are a very small fraction of the total costs C_p and C_d . Note that the case in which both sides hire lawyers on hourly fees features fine divisibility of this sort.

round, and each party is equally likely to be the offerer.¹¹ After the offer is made, the other party may either accept it (i.e., a settlement is reached) or reject it. In the event that the offer is rejected, the plaintiff will proceed to the next stage (because the plaintiff's suit is assumed to have a positive expected value, the plaintiff will never elect to drop it). It will be assumed that the parties have no commitment mechanisms -- such as ones grounded in reputation -- that would enable them to bind themselves to a particular course of action.

For simplicity, both parties are assumed to be risk-neutral. It is also assumed that π , J , $\{c_p^i\}$ and $\{c_d^i\}$ are common knowledge. Finally, the parties are assumed to have identical discount rates. All money values at periods $i > 0$ are expressed in terms of their present value at $i=0$. In particular, J , $\{c_p^i\}$ and $\{c_d^i\}$ are all expressed in terms of their present value at $i=0$.

The set-up described above is appropriate for a study that focusses on settlement terms. Because there is no informational asymmetry, the parties will reach a settlement -- regardless of the fee-shifting rule in place -- before any litigation costs are expended.¹² The fee-shifting rules will, however, affect the settlement amount.

¹¹In modeling multi-period bargaining, it is conventional to assume that in every period each party is equally likely to be the offerer. The alternative conventional formulation, in which the two parties alternate roles, would produce similar results.

¹²When parties differ in their information, a settlement might fail to take place. See Lucian A. Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. ECON. 404 (1984); Kathy Spier, *The Dynamics of Pretrial Negotiation*, 59 REV. ECON. STUD. 93 (1992).

III. THE BARGAINING

To analyze the bargaining game, it is necessary to understand what would happen if the case ended in a judgment. If the case were to reach the judgment stage, the expected outcome would be a function of the cost allocation rule. Recall that we have denoted the likelihood that the plaintiff will get his fees reimbursed by the defendant by P_p , and the likelihood that the defendant will get her fees reimbursed by the plaintiff by P_d . The expected award at the judgment stage, therefore, is:

$$(1) \quad \begin{aligned} A &= \pi J + P_p C_p - P_d C_d \\ &= W + P_p C_p - P_d C_d. \end{aligned}$$

Knowing the expected outcome at trial allows us to examine how the anticipation of such an outcome affects settlement terms. We will analyze the bargaining game by backward induction, beginning with the final round of bargaining. Suppose that the parties reach this final round. If the plaintiff makes the settlement offer, he will offer an amount, S_p^n equal to the highest amount that the defendant will be willing to accept:

$$(2) \quad \begin{aligned} S_p^n &= A + c_d^n \\ &= W + P_p C_p - P_d C_d + c_d^n. \end{aligned}$$

If, on the other hand, it is the defendant who makes the offer, her offer, denoted S_d^n , will equal the lowest value acceptable to the plaintiff:

$$(3) \quad \begin{aligned} S_d^n &= A - c_p^n \\ &= W + P_p C_p - P_d C_d - c_p^n. \end{aligned}$$

Since each party is equally likely to be making the offer in round n , the expected

value of the settlement, conditional on the parties reaching round n , is:

$$(4) \quad \begin{aligned} S^n &= \frac{1}{2}(S_p^n + S_d^n) \\ &= A + \frac{1}{2}(c_d^n - c_p^n) . \end{aligned}$$

Now consider rounds prior to the last round. In each round the parties will bargain with the knowledge of the settlement terms that would be expected in the next round if they were to fail to reach an agreement in this round. So, if the plaintiff makes the offer in round i , he will propose:

$$(5) \quad S_p^i = S^{i+1} + c_d^i .$$

If the defendant makes the offer in round i , she will offer:

$$(6) \quad S_d^i = S^{i+1} - c_p^i .$$

The expected value of the settlement amount in round i is, therefore,

$$(7) \quad S^i = S^{i+1} + \frac{1}{2}(c_d^i - c_p^i) .$$

By substituting the values of S^{i+1} all the way to S^i we get:

$$(8) \quad S^i = A + \frac{1}{2} \left(\sum_{j=1}^n c_d^j - \sum_{j=1}^n c_p^j \right) .$$

Once we reach the first round of bargaining, the backward induction is complete and yields the expected settlement amount. Our conclusion is summarized by the following Lemma.

LEMMA: The expected settlement amount in the case will be:¹³

$$\begin{aligned}
 (9) \quad S &= A + \frac{1}{2}(C_d - C_p) \\
 &= W + P_p C_p - P_d C_d + \frac{1}{2}(C_d - C_p) .
 \end{aligned}$$

IV. COMPARING THE BRITISH AND AMERICAN RULES

We are now in a position to apply the general conclusion reached in the preceding section to each cost allocation rule. By doing so we will be able to identify and compare the expected settlement terms under the alternative fee-shifting rules. We will start with the two basic rules that have attracted the most attention.

A. Expected Settlement Under the American Rule

We begin with our baseline case -- the American rule of no fee-shifting. Under this rule, because there will never be a court ordered reimbursement of fees, P_p and P_d are both zero. Applying the Lemma, therefore, we get the following proposition:

PROPOSITION 1: Under the American Rule, the expected settlement amount is:

$$S = W + \frac{1}{2}(C_d - C_p) .$$

¹³Note that if the litigation costs are finely divisible, then c_p^i and c_d^i are very small for any i . Equations (5) and (6) demonstrate that the offer actually made by the plaintiff or the defendant will differ from S by c_d^i and $-c_p^i$ respectively. It is therefore the case that for finely divisible litigation costs, the actual settlement will be (approximately) equal to the amount given in equation (9).

Remark: It is worthwhile noting one aspect of the outcome under the American Rule.¹⁴

Compared to the expected judgment, the expected settlement under the American rule favors the party with lower litigation costs. In other words, if C_p and C_d differ, S will diverge from W in a direction that is favorable to the party that has lower litigation costs. If $C_p > C_d$, S will be below W ; if $C_p < C_d$, S will exceed W .

B. Expected Settlement Under the British Rule

Under the British rule, the losing party is always required to reimburse the winning party for the latter's litigation costs. Given that π is the likelihood that the plaintiff wins and $1-\pi$ is the likelihood that the defendant wins, we have $P_p = \pi$ and $P_d = 1-\pi$. The expected award under the British rule is, therefore, $A = W + \pi C_p - (1-\pi)C_d$. Applying the lemma, the expected settlement under the British rule is:

$$(11) \quad S = W + \pi C_p - (1-\pi)C_d + \frac{1}{2}(C_d - C_p) .$$

Rearranging terms yields our next proposition:

PROPOSITION 2: Under the British rule, the expected settlement amount is:

$$S = W + (\pi - \frac{1}{2})(C_p + C_d) .$$

Remark 1: Intuition. The result obtained above can be reconciled with one's intuition as follows. Under the British rule, the plaintiff expects to bear the total litigation costs ($C_p + C_d$)

¹⁴This aspect is the focus of the analysis in Lucian A. Bebchuk, *On the Difference between Settlement Terms and the Expected Judgment*, mimeo (1996).

with probability π . The plaintiff's "real" litigation cost under the British rule, denoted C_p^B , are, therefore, $\pi(C_p + C_d)$. Similarly, the defendant's "real" litigation costs, denoted C_d^B , are $(1-\pi)(C_p + C_d)$. Note that the second term on the right hand side of Proposition 2 can be expressed as $\frac{1}{2}(C_d^B + C_p^B)$. Thus while the expected settlement under the American rule is $W + \frac{1}{2}(C_d + C_p)$, the expected settlement under the British rule is $W + \frac{1}{2}(C_d^B - C_p^B)$.

Remark 2: Comparison with the Expected Judgment. Under the British rule, the expected settlement equals the expected judgment only if $\pi=1/2$. When π differs from $1/2$, the parties "real" litigation costs under the British rule, C_p^B and C_d^B , differ. When these costs differ, the expected settlement will diverge from the expected judgment in a direction that is favorable to the party whose real litigation costs are lower -- the plaintiff if $\pi > 1/2$ and the defendant if $\pi < 1/2$.

C. The Effect of the British Rule on Settlement Terms

We will now compare the expected settlement under the British rule with the expected settlement under the American rule. That is, we will examine the effect shifting from the American rule to the British rule would have on the expected settlement.

1. Which Party Gains?

An initial perspective from which we will consider the issue is the effect of the rule on the parties -- who wins and who loses from a change in the rule. Comparing propositions 1 and 2, we see that a shift from the American rule to the British rule would increase the expected settlement amount if and only if:

$$(13) \quad (\pi - \frac{1}{2})(C_p + C_d) > \frac{1}{2}(C_d - C_p) .$$

Re-writing this expression, (13) yields proposition 3.

PROPOSITION 3: Compared to the American rule, the British rule improves the plaintiff's position (and worsen's the defendant's position) if and only if:

$$\frac{C_p}{C_p + C_d} < (1 - \pi) .$$

Remark: This proposition can be explained intuitively as follows. Under the American rule, the expected fraction of the total litigation costs borne by the plaintiff is $C_p/(C_p+C_d)$. In contrast, under the British rule, the expected fraction of the total litigation costs borne by the plaintiff is $(1-\pi)$. A shift to the British rule will help the plaintiff if it would reduce the expected fraction of the total litigation cost borne by the plaintiff, which occurs if $C_p/(C_p+C_d) < 1-\pi$.

2. The Effect on the Divergence between Expected Settlement and Expected Judgment

A second perspective from which to consider the shift from the American rule to the British rule is the effect of the change on the relationship between the expected settlement and the expected judgment. Under the American rule, the size of the gap between the expected settlement and the expected judgment is $|\frac{1}{2}(C_d - C_p)|$. Under the British rule, the size of the gap between the expected settlement and the expected judgment is

$|\pi - \frac{1}{2}|(C_p + C_d)|$. This yields proposition 4.

PROPOSITION 4: The expected settlement is closer to the expected judgment under the British rule than it is under the American rule if and only if:

$$\left| \pi - \frac{1}{2} \right| < \left| \frac{1}{2} \left(\frac{C_d - C_p}{C_p + C_d} \right) \right|.$$

Remark: Proposition 4 can be explained intuitively as follows. Under both rules, the extent to which the expected settlement diverges from the expected judgment depends on the extent to which the parties' litigation costs differ. Under the American rule, the extent to which the costs differ depends on the difference between C_d and C_p . Under the British rule, the extent to which the costs differ depends on how much π differs from $\frac{1}{2}$.

Finally, it is worth noting that a shift to the British rule might reverse the direction of the divergence of the expected settlement from the expected judgment. In particular, we have:

PROPOSITION 5: Under the British rule, the expected settlement will diverge from the expected judgment in the opposite direction than under the American rule if and only if:

$$\text{sign}(C_d - C_p) \neq \text{sign}\left(\pi - \frac{1}{2}\right).$$

Therefore, if $C_d > C_p$ and if $\pi < \frac{1}{2}$, then the expected settlement will exceed the expected judgment under the American rule but will fall below the expected judgment under the British rule. Conversely, if $C_d < C_p$ and $\pi > \frac{1}{2}$, the expected settlement will fall

below the judgment under the American rule but will exceed the expected judgment under the British rule.

V. PRO-PLAINTIFF AND PRO-DEFENDANT RULES

Having considered the effect of the British rule -- under which there is double-sided fee shifting -- we now proceed to an analysis of the pro-plaintiff/pro-defendant rules under which there is fee shifting only if the plaintiff/defendant wins.

A. Expected Settlement

Under the pro-plaintiff rule, if the plaintiff wins, which occurs with probability π , the plaintiff gets an extra C_p . Under this rule, therefore, the expected award is $A = W + \pi C_p$.

Applying the Lemma derived in Section III, we have:

PROPOSITION 6: Under the pro-plaintiff rule, the expected settlement amount is:

$$\begin{aligned} S &= W + \pi C_p + \frac{1}{2}(C_d - C_p) \\ &= W + \frac{1}{2}[(C_d + \pi C_p) - (1 - \pi)C_p] . \end{aligned}$$

Remark: This result can be explained in an intuitive fashion as follows. Under the pro-plaintiff rule, the plaintiff's real litigation costs are $C_d + \pi C_p$. Thus, as before, the expected settlement is equal to W plus half the excess of the defendant's real litigation costs over the plaintiff's real litigation costs.

Under the pro-defendant rule, the outcome is reversed. The plaintiff has no chance of

getting his fees reimbursed and will have to reimburse the defendant with probability $1-\pi$.

The expected award is, therefore, $A = W - (1-\pi)C_d$, which yields proposition 7.

PROPOSITION 7: Under the pro-defendant rule, the expected settlement amount is:

$$\begin{aligned} S &= W - (1-\pi)C_d + \frac{1}{2}(C_d - C_p) \\ &= W + \frac{1}{2}[\pi C_d - (C_p + (1-\pi)C_d)] . \end{aligned}$$

Remark: As before, the second term on the right hand side of proposition 7 is one half of the defendant's "real" litigation costs over the plaintiff's "real" litigation costs.

B. The Effect of the Rules

As we did in Section IV, we will examine the effect of the rules both in terms of how they affect the parties' interests and how the expected settlement compares with the expected judgment.

1. Which Party Gains?

Comparing proposition (6) with propositions (1) and (2), we can establish the following.

PROPOSITION 8: The expected settlement under the pro-plaintiff rule is higher than the expected settlement under either the American rule or the British rule.

Under the pro-plaintiff rule, the plaintiff's expected fraction of the total litigation costs is smaller than under either the British or the American rule. For this reason, the pro-

plaintiff rule produces settlement terms that are more favorable to the plaintiff than under other rules.

Comparing proposition (7) with propositions (1) and (2) establishes:

PROPOSITION 9: The expected settlement is lower under the pro-defendant rule than it is under either the American rule or the British rule.

This proposition holds because under the pro-defendant rule, the expected fraction of the total litigation costs borne by the plaintiff is higher than under the alternative rules.

2. The Effect on the Divergence between Expected Settlement and Expected Judgment

As was done in Section IV, it is possible to assess the pro-plaintiff and pro-defendant rules also from the perspective of how they affect the difference between the expected settlement and the expected judgment. To illustrate these effects, we will limit ourselves to the following observations.

Consider first the case in which the expected settlement exceeds the expected judgment under the American rule, the British rule, or both. In this case, the pro-plaintiff rule would lead to an even greater divergence in favor of the plaintiff. In contrast, the pro-defendant rule would reduce, and might even reverse, the divergence that exists under the American or British rules.

On the other hand, if the expected judgment falls below the expected judgment under the American rule, the British rule, or both, then the pro-defendant rule would lead to an even greater divergence in favor of the defendant and the pro-plaintiff rule would decrease

and might even reverse the divergence.

VI. CONCLUSION

This paper has focussed on an effect of fee-shifting rules that has been largely ignored in the existing literature -- their effect on settlement terms. The analysis has demonstrated that fee-shifting rules do indeed have a substantial effect on settlement terms. The analysis has identified the effect on settlement terms of each of the basic fee-shifting rules. The analysis has also examined how these consequences of fee-shifting rules affect the parties (who gains and who loses) and the relationship between the expected settlement and the expected judgment. The identified effects of fee-shifting rules on settlement terms should be taken into account in any policy examination of such rules.