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REVERSE-COST-SHIFTING: A NEW PROPOSAL FOR ALLOCATING LEGAL EXPENSES

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Abstract

The two traditional mechanisms for allocating the costs of litigation, the American and European rules, have been extensively studied in terms of their impact on litigation. This analysis proposes a third alternative, the reverse-cost-shifting (RCS) rule. In contrast to the American rule (where each party pays its own costs), and the European rule (where the losing party pays at least some of the winner's costs), RCS imposes on the losing party a penalty determined by its own costs, which is paid directly to the court. Using a formal analytic model, the comparative consequences of the three allocation rules are assessed in terms of their impact on the decision to litigate. It is shown that among the three rules, RCS provides the strongest deterrent against a party over-investing in its case, particularly if that case is weak. This has significant policy implications for controlling the growth of litigation costs. These and other policy questions are discussed in some detail.

INTRODUCTION

This analysis explores a topic that has been widely treated with varying results and conclusions. The allocation of attorneys' fees and other costs of litigation is an important consideration for potential litigants and others using dispute resolution processes, and it is a concern for the judicial system generally.1

* Professor of Physics, and Associate Professor of Political Science, Purdue University, respectively. We thank Michelle Parry for assistance with the numerical results. We are also indebted to Daniel Bernstein, the Hon. Gregory Donat, the Hon. Michael Gery, Richard Meister, Michael Morin, and John Scheid for helpful discussions, and to Judy Hanks and Nancy Schnepp for assistance in manuscript preparation.

1. The literature on the subject of attorneys' fees is voluminous. Only the major works will be cited here but these, along with the sources cited in them, provide a comprehensive treatment of the scholarly literature. Lucian Arye Bechchuk & Harold F. 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. LEGAL STUD. 371 (1996); Donald N. Dewees et al., An Economic Analysis of Cost and Fee Rules for Class Actions, 10 J. LEGAL STUD. 155 (1981); John J. Donohue III, Commentary—Opting for the European Rule, or if Posner and Shavell Can't Remember the Coase Theorem, Who Will?, 104 HARV. L. REV. 1093 (1991); William J. Lynk, The Courts and the Plaintiffs' Bar: Awarding the Attorney's Fee in Class Action Litigation, 23 J. LEGAL STUD. 185 (1994); Thomas J. Miceli, Do Contingent Fees Promote Excessive Litigation?, 23 J. LEGAL STUD. 211 (1994);
This subject has also been of interest to various scholars over recent decades because of questions relating to the increase in litigation in this country and the impact of this increase on our judicial system. In addition, there is growing interest in the impact of cost allocation on the decisions that disputants make. While this inquiry will not treat the entire subject, it will provide an alternative rule for allocating litigation costs and attorneys' fees, and it will compare the prominent allocation rules using a new analytic approach.

With some variation, there are two primary allocation formulas that have drawn most of the scholarly and policy attention. The first is the American rule which, in its purest form, requires each party to pay its own costs no matter the outcome of the dispute or contest. That is, irrespective of how the dispute is resolved—settlement or judgment—and no matter who prevails—plaintiff or defendant—the costs of litigating lie where they fall. Without regard to the amount paid or to the source of the payment, winners pay their own costs and the losers pay theirs. The other rule is usually called the European (or British) rule, and it results in some distribution of costs from the losing party in the case to the winner (either the loser pays all the costs of the winner or some portion thereof). The European rule is designed both to impose an additional sanction on the losing party for initiating or defending a case without merit and to make the winner "whole." The European rule provides the prevailing party with additional compensation, so that its "winnings" do not have to be devoted to the contest.

In addition to the American and European rules for allocation, legislatures and courts in this country have developed other allocation rules relating to specific kinds of litigation. In fact, the American rule has been altered by a number of federal statutes that provide numerous opportunities for the "prevailing party" to collect


"reasonable attorneys’ fees.” These provisions have led to a good
deal of litigation and judicial modification. Such two-way cost
shifting provisions allow for the courts to determine when a party is
the “prevailing party.” The determination of what constitutes “rea-
sonable” attorneys’ fees also provides room for judicial modification
of the statutory allocation rule. The bulk of these laws change the
American rule into some form of the European rule by requiring the
losing party to reimburse the winning party for attorneys’ and other
fees.

There are also common law examples of courts in the United
States modifying the American rule to impose the winning party’s
attorneys’ fees on the losing party. Some of these appear to involve
efforts to impose a punitive sanction on a party who takes and
maintains a frivolous or non-meritorious position in a case. There
are also examples of courts imposing fees on the loser in order to
achieve the other objective of the European rule, namely, to make
the winner whole.

These variations from the American rule are generally two-way
fee shifting. That is, they allow the fees to be shifted from plaintiffs
to defendants as well as from defendants to plaintiffs. The only
factor determining the direction of the shift is that it occurs from
the loser to the winner. In contrast, one-way fee shifting works from
only one party (usually the defendant) when it loses to the other
(usually the plaintiff) when it wins. This examination focuses on a
different kind of shifting, but it can be classified as two-way since
the discussion relates to the possibility that whichever party loses
will be held responsible for fees.

3. Various compilations of the statutory provisions in the United States
Code include Aleyska Pipeline Co. v. Wilderness Society, 421 U.S. 240, 260-61
(1975); Jeffrey Goodstein, Attorney’s Fees: Winning a Recovery in Federal
Court (1985).

   b) ATTORNEY’S FEES: In any action or proceeding to enforce a provision . . .
   the court, in its discretion, may allow the prevailing party, other than the
   United States, a reasonable attorney’s fee as part of the costs.
   c) EXPERT FEES: In awarding an attorney’s fee under subsection (b) of this
   section in any action or proceeding to enforce a provision . . . the court, in
   its discretion, may include expert fees as part of the attorney’s fee.

   The Supreme Court’s interpretation of this statute has evolved a good deal,
   and it illustrates several elements of judicial interpretation and discretion re-
   garding this matter. See Farrar v. Hobby, 506 U.S. 103 (1992); see also Christians-

5. See, e.g., Farrar, 506 U.S. at 103; Burlington v. Daque, 505 U.S. 557


8. See The Natural Gas Pipeline Safety Act, 49 U.S.C. § 1671 for an exam-
   ple of a one-way fee shifting rule. This is not a purely one-way provision since
   the allocation of fees can go either way, but it does illustrate differential treat-
   ment of plaintiff and defendant in allocation mechanisms.
These fee allocation rules have consequences for the two primary choices that are made by disputants: (1) the decision to litigate (initiating or defending against a suit) and (2) the decision to settle (bargaining or compromising) or litigating to a conclusion once the case has been initiated.\(^9\) The consequences of these rules arise from the fact that the costs each party incurs influence its decision regarding whether to litigate, \textit{i.e.}, initiate a law suit, and then whether to take the case to judgment or settle via negotiation. These allocation mechanisms have been explored by a variety of scholars, and various statutory modifications to each of these rules have been made in order to adjust outcomes and consequences.\(^10\)

The analysis presented here seeks to accomplish two objectives that differ from prior research. First, a new allocation rule is developed and analyzed. The objectives of this rule differ from the goals of both the American and European rules. While this rule may seem out of the ordinary in the American context, it produces results that may be beneficial for the judicial process in this country. Furthermore, the consequences of this rule are different from the two traditional rules of fee allocation. This analysis will compare the existing paradigms for allocating the cost of litigation with this proposed alternative. The research builds on the earlier work of other authors, and places this third allocation rule in the context of existing models, with rather striking results.

Second, this analysis compares the three cost allocation rules that are discussed using a new framework. Much of the prior research has treated the probability of winning (or losing) as though it can be objectively determined, is known (and is constant) to everyone, or is unilaterally within each party's control.\(^11\) It is usually also assumed that the probability of winning a suit is a fixed, deter-

\(^9\) 49 U.S.C. § 1686(e) provides:

In any action under this section the court may, in the interest of justice, award the costs of suit, including reasonable attorney's fees and reasonable expert witnesses fees, to a prevailing plaintiff. Such court may, in the interest of justice award such costs to a prevailing defendant whenever such action is unreasonable, frivolous, or meritless. For purposes of this subsection a reasonable attorney's fee is a fee (1) which is based upon (A) the actual time expended by an attorney in providing advice and other legal services in connection with representing a person in an action brought under this section, and (B) such reasonable expenses as may be incurred by the attorney in the provision of such services, and (2) which is computed at the rate prevailing for the provision of similar services with respect to actions brought in the court which is awarding such fee.

See Cooter & Rubinfeld, \textit{supra} note 1 (indicating the nature of the analysis that accompanies these two questions). \textit{See also} Note, \textit{An Analysis of Settlement}, 22 STAN. L. REV. 67 (1969); \textit{see also} Shavell, \textit{supra} note 1.

\(^10\) See, \textit{e.g.}, Shavell, \textit{supra} note 1; \textit{see also} Ronald Braeutigam et al., \textit{An Economic Analysis of Alternative Fee Shifting Systems}, 47 LAW & CONTEMP. PROBS. 173 (1984).

minable value (between 0.0 and 1.0). However, it is much more realistic to view this probability as a function which depends on a variety of factors, some of which each party can control. In the following analysis, the probability $P$ of the plaintiff winning, and the probability $\bar{P}$ of the defendant prevailing, will be treated as functions, which depend on variables such as the investment made by each side.

The research presented below is organized into several parts. Section II presents an alternative fee-shifting model called the reverse-cost-shifting (RCS) rule. This presentation discusses the RCS rule and a variety of substantive (policy) considerations that arise from this proposal for allocating the costs of litigating. Section III provides the formal analysis of the RCS rule and compares the consequences of the American, European, and RCS cost allocation schemes. This assessment of the three rules and their consequences is presented in both qualitative and quantitative terms, and in the context of a more sophisticated and formal model. Additionally, this article illustrates the impact of the RCS rule using several examples. Section IV outlines what the RCS rule can be expected to achieve in comparison with the American and the European rules. This provides a clear sense of the relative features of these three rules. Section V concludes the analysis and raises several important policy considerations for future research.

II. FORMULATION OF THE REVERSE-COST-SHIFTING PROPOSAL

A. The Reverse-Cost-Shifting Rule

In this section, a detailed formulation of the (RCS) rule is presented. The purposes and consequences of RCS differ from those of the American or European rules discussed in the previous section, and these differences will be further explored in Sections III and IV below. The rule in its simplest form is as follows:

In civil actions, the losing side pays a multiple of its own costs to the court.

This multiple, called the compensation factor ($C$), would be fixed by law in each jurisdiction. In the simplest case, where $C = 1$, the losing side would pay to the court a fine or "user's fee" exactly equal to its own expenses. This rule is referred to as reverse-cost-shifting since the penalty levied against the losing side is determined by the expenditures of the losing side, rather than by the expenses of the winning side as under the European rule.

The RCS rule is quite different from either the American or European rules, although it shares some features with each. In qualitative terms, the RCS rule aims to discourage a party (either plaintiff or defendant) whose case is weak from pursuing its case through litigation. The deterrence is provided by the prospect of an
additional penalty which would be levied against the losing party, as under the European rule. However, in contrast to the European rule, the penalty is determined by the loser's own expenses. This has the effect of encouraging each party to limit its investment in its own case. The quantitative results presented in Section III below suggest that in practical terms the effect of RCS would be to encourage each party to invest resources in a case only to the point where this investment increases its expected gain. Any additional investment is discouraged, as it increases each party's penalty should it lose while not materially contributing to it's probability of winning.

The RCS rule also differs from the European rule in having the penalty paid to the court rather than to the winner. Thus RCS shares with the American rule the provision that the winning party recovers only the value of the judgment — not its legal expenses. The reasons for having the court receive the penalty are detailed below.

The purpose of the RCS rule is to affect the strategic behavior of each party (their decisions and choices about litigating a case) just as any allocative rule does. One of the significant features of RCS is that it does not allocate resources between litigants, as is the case under the European rule. Nonetheless, the rule is still allocative or distributive in its effect, since it assesses litigation costs against the losing party in each case, as does the European rule.

Notwithstanding their differences, the American, European, and RCS rules share the assumption that courts function effectively and rationally to settle conflicts or disputes. The mechanism through which RCS acts to discourage non-meritorious or "frivolous" lawsuits (see Section III below), depends on the assumption that the courts will make rational, predictable decisions based on the objective merits of each party's case. This assumption seems defensible for purposes of this analysis, even though courts may serve other functions as well.

In addition to assuming that courts resolve disputes, an assumption should be made that the litigants and their attorneys act rationally. This is particularly the case for RCS where each party must assess its probability of winning, as discussed in more detail below. Thus, RCS encourages more thoughtful estimates of the risks and the likelihood of prevailing by attorneys and clients at all stages in the litigation process. This undoubtedly requires more careful consideration of the arguments advanced by attorneys, and

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12. This analysis treats only the decision to litigate, not the related decision whether to litigate or settle a dispute. However, RCS does affect the decision to litigate or settle, just as any cost allocation system would.
the provision of more information to litigants than might now occur. It is also likely to increase the control a litigant has over a case.

Furthermore, under RCS, lawyers would likely be pressed by their clients to calculate the risks (probability) of losing or prevailing in the suit more accurately. This may already be done in some cases, although indications from current litigation and strategic behavior suggest that such calculations are often casual, not considered seriously, inaccurately optimistic, or even non-existent for some litigants.\textsuperscript{13} The prevailing American rule encourages imprecise calculations, perhaps even wildly inflated guesses — about the chances of winning.

It is also often the situation that the purpose of filing a complaint is merely to increase the pressure on the opposing side to bargain. Such cases clog the courts and are not prosecuted because the plaintiffs do not intend to prosecute. This type of strategic behavior could be discouraged or penalized under the RCS rule.\textsuperscript{14}

The RCS rule would reduce the number of cases initiated in the courts, or brought to a conclusion through litigation. The rule would accomplish this through the imposition of additional, and perhaps very significant, costs on parties if they do not carefully calculate litigation strategies and case development efforts. In particular, frivolous suits or highly risky claims of various kinds would be discouraged. This should produce benefits to the judicial system, the government generally, and society at large, in the form of less litigation over non-meritorious claims.

One of the unique features of this proposal is that the costs are paid to the court, rather than to the winning party. This underwrites the public's costs of maintaining a public dispute resolution system (the courts). The “users” of the system directly pay at least some of the costs of maintaining the system under this rule.

In contrast to the European rule, the objective of the RCS rule is not to make the winner whole, to reward the winning party for litigating or for maintaining its position, or to redound to the benefit of the prevailing party. Rather, its purpose is to deter the losing party from litigating or persisting in litigation that has little or no merit. That purpose is served by making the judicial system the recipient of the allocation. The courts can be viewed as a public good and as an essential part of governance. However, the judicial

\textsuperscript{13} See, e.g., \textsc{Lawrence Friedman}, \textit{Total Justice: What Americans Want from the Legal System and Why} (1985) (discussing plaintiffs' calculations of fees). See also \textsc{Jonathan Harr}, \textit{A Civil Action} (1995).

\textsuperscript{14} This might be called the “run it up the flagpole and see” strategy. Such an assessment of the merits of a case is really a non-calculation, since the litigant/attorney is simply willing to contest the issue with no idea of the likelihood of success. The hope of this litigation strategy is to get “something” from the other party, through either the threat of litigating, bargaining to a compromise result, or litigating to a judgment.
system incurs substantial resource costs from being "open" for lawsuits. Under RCS some of the costs that litigants impose on the system for frivolous or questionable lawsuits, are paid by the losing parties rather than by general tax revenues.

There is an additional reason why the losing party pays the court under RCS, rather than the winning party as under the European rule. Suppose an alternative rule exists, called RCS2, which is the same as RCS except that the loser pays the winner rather than the court. Under RCS2 an individual who prevailed in a suit against a large corporation could reap an undeserved "windfall" as the recipient of the losing party's RCS penalty. This windfall would be the difference between the winner's actual costs and the (presumably much larger) costs of the loser in such a case. The potential for such a windfall might even encourage certain kinds of litigation, rather than discourage litigation which is the primary objective of RCS. Since there is no overarching societal benefit that results from having the RCS2 penalty paid to the winning party in such a circumstance, the most obvious recipient is the court system itself, as in RCS. Hence by having the penalty paid to the court, RCS not only supports the courts, but also discourages litigation whose primary purpose would be to reap a windfall that might result under RCS2.

B. Possible Exceptions to Reverse-Cost-Shifting

Since the RCS rule shares with the European rule the feature that a penalty is levied against the losing party, it is appropriate to consider some exceptions which are suggested by the European experience. These exceptions involve either certain types of parties or certain kinds of cases.

1) Non-monetary cases. A general exception could be made for cases where the underlying issue is one of "equity" rather than money. Examples of this might include child custody, immigration, desegregation cases, or any other action where the requested remedy is equitable. The reason for making this exception is that the RCS rule presumes that each party will be discouraged from pursuing a weak or non-meritorious case when the party decides that it stands to lose more money than it will gain. Unless the outcome of a case can be expressed as an expected monetary gain or loss, the motivation behind the RCS rule is absent, and the rule would not have the intended effects. Furthermore, cases of this sort involving qualitative outcomes may be socially desirable, and should not be deterred by a cost allocation rule such as RCS.

2) Sovereign immunity. The RCS penalty could be waived if the losing party is any governmental unit or agency. The rationale for this exception is that by imposing a fine on the government (when it
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is the losing party) one would merely be transferring funds from one governmental unit to another (the court), and this serves no societal purpose. Moreover, waiving the RCS penalty in such a circumstance would not eliminate the deterrence against overinvestment provided by RCS, since governmental budgets are always limited, and are also subject to public scrutiny. In any event, the winning party is not disadvantaged under such an exception, since they are not the recipients of the penalty under RCS. This contrasts with the situation under the European rule, where an analogous exception would penalize the winning party by depriving it of the compensation for legal expenses which might otherwise have been received.

3) **Legal-Aid clients.** Since Legal-Aid may be funded from governmental sources or private charities, this penalty could be waived in such cases for reasons similar to those discussed in 2) above. Stated another way, since the litigant is using the litigation resources of a public third party, the RCS penalty would not act as a deterrent to this litigant or this litigation.

4) **“Sui generis” cases.** The philosophy behind RCS is that society should discourage litigation in circumstances where one or the other side is presumed to know that it has a weak case. When a unique or broad new legal issue is brought to the courts, the RCS penalty seems inappropriate, because neither party can calculate the probability of winning, or the costs of winning. Furthermore, society derives a general benefit from such litigation—the clarification of a legal principle or the development of a legal rule. Litigation of this sort should not be discouraged.

5) **Resolution of judicial conflicts.** Litigation which has as one of its purposes the resolution of a conflict among the circuits, or among decisions handed down by different courts, could serve the public interest. In such cases the RCS penalty can be waived. Moreover, both the qualitative and quantitative features of RCS presume that each party has a basis for assessing how strong a case it has. When an issue arises over which the courts themselves disagree, the imposition of a penalty on the losing side would seem inappropriate.

6) **Writs of habeas corpus.** Such petitions arise from criminal prosecutions and hence can be viewed as particular examples of “non-monetary” cases discussed in 1) above. Furthermore, the petitioners in these cases (prisoners) may be “judgment-proof" and thus have nothing to lose, even under the RCS rule. The nature of these proceedings — the validity of the incarceration — also seems to mitigate against imposing a cost penalty on the losing party (petitioning prisoner or responding jailer). On the other hand, the state
may wish to impose an RCS penalty in the form of a nominal flat fee, to discourage frivolous habeas corpus petitions.

7) Mandatory no-fault proceedings. An example would be a no-fault divorce where a court proceeding is mandated by law. Even though there may be monetary issues at stake (e.g. property settlement and support), the fact that court proceedings are mandated in such a case precludes the parties from avoiding a court appearance even if they wished to do so. Under such circumstances it would seem appropriate to waive the RCS penalty.

The preceding exceptions are flexible, in the sense that any or all can be dropped, and others added, without changing the basic operation of RCS as formulated in the rule. Since these exceptions (and possibly others) will have an impact on general litigation patterns, by encouraging some kinds of litigation and discouraging others, legislatures should consider such exceptions as important policy issues from the outset, and in subsequent statutory adjustments or changes to the allocation policy.

C. Implementation of the Reverse-Cost-Shifting Rule

Although the RCS rule is straightforward, its practical implementation requires attention to several features. First, all the costs incurred by the losing litigant must be included and calculated under the RCS rule. This requires some changes in the current process. This rule views the cost of litigation as the costs of the suit imposed on the parties and their representatives. Furthermore, the costs an attorney has in the case, even if there are no immediate costs from filing the suit, must be reflected in the "costs" under this rule. This means that even if the attorney only uses "free time," the value of this time and other existing resources (e.g. clerical, software, and office/library) would be accounted for in the cost assessment. Those costs must be itemized and paid in connection with each case. Each suit an attorney files must be accounted for in terms of the attorney's time and other resources that are used in the process of that particular suit, no matter how small that cost is to the attorney or the litigant. In short, this provision requires that the real cost of the case be accounted for, rather than just the marginal cost of filing this particular case. A determination of the costs under RCS might be fixed by statute if attorneys are unable to identify and specify costs in some situations.

Second, in addition to attorneys' actual costs, the costs of collecting evidence for the case must be clearly documented and included. Whether this is the cost of investigation time, witness fees, or evidence analysis, all of these are real costs that determine the quality of the case (the evidence) presented by each party. These costs should provide an incentive for each party (and attorney) to
incure only those evidence costs that increase the likely gain from winning the case. Thus, evidentiary "overkill" and its expense should be deterred by this rule. The analysis in Section III indicates how this consideration operates in connection with the RCS rule, by determining when the attorney and client will decide not to invest any more time and money in case development. This rule is likely to make that point come earlier in the investment process, or at the very least force the parties to calculate these costs more carefully.

Evidence that is beyond a party's control, i.e., in the control of the opponent or some third party, might be excluded from the cost accounting. This provision may require petitioning the court to recognize the opponent's dilatory tactics or obfuscation of evidence that is in their possession. It would also provide some incentive for parties to specify their evidence requests precisely rather in general, "fishing-expedition" terms.

The cost of each piece of evidence should be calculated and accounted for in this system. That may seem unrealistic, but the usual procedures involved in the development of evidence are well known and could be documented with little difficulty. For certain services or kinds of legal services, fees could be fixed by law or set by a regulatory agency if the legislature determined that would best serve the public's interests. This would mean that the costs for some kinds of legal services might be known (i.e. fixed) for everyone considering litigation. The reasons for such a public determination of some costs (or determination in advance) include the difficulty of establishing these in individual cases, the chance that some costs could be avoided (not specified) by the loser or their attorney unless required or set by law, and the recognition that some costs might be common or universal regardless of the party, the lawyer, or the type of case. The legislature could identify and specify such costs to ensure that parties could not avoid them. Such cost-setting might also deter or encourage various decisions about initiating suit on the part of attorneys and clients.

Third, the RCS rule requires the determination of winners and losers in litigation. In some cases the winner is obvious from the outcome, but in a variety of instances the outcome is not at all clear or explicit. Since RCS applies only to those civil cases where monetary damages are being sought, it is reasonable to define "winning" in terms of the fraction of the damages asked for that is actually awarded by the court. Hence a plaintiff who sues for $1,000, but is

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15. A side consequence of the RCS rule would be that parties would tend to specify damages more accurately rather than inflate their damage requests. The reason for this is that inflated damages are more likely to result in a reduced (less than full) jury award. This outcome would result in the assessment of some proportion of costs on the winning plaintiff because they did not win the
awarded only $800, would be considered as an "80% winner and 20% loser" under this definition. Contrariwise, the defendant in this case would be "20% winner and 80% loser." The plaintiff who spent \( x \) dollars would thus pay 20% of the RCS penalty \( C_x \), whereas the defendant who spent \( y \) dollars would pay 80% of the RCS penalty \( C_y \). This apportionment of the RCS penalties between plaintiff and defendant could also operate when the legal system uses comparative negligence mechanisms.

The apportioning of legal costs in this manner assumes that the plaintiff can in fact specify the damages he is seeking. This may not always be the case initially if the amount of damages being sought depends on facts which will only emerge later, either during discovery or during the trial itself. However, at some stage in a trial the plaintiff will presumably ask for a specific dollar amount, and this amount (along with the actual court award) will then determine what fraction of the maximum RCS penalties the plaintiff and defendant will pay.

In a case where the plaintiff sues the defendant under a number of different theories, the disposition of each of these theories may be important for case law, but only the final monetary award is relevant for determining the RCS penalty for each side. Since the other consideration in determining the RCS penalty is the amount sought by the plaintiff, the RCS mechanism discourages a plaintiff from asking for a great deal more than he is likely to win, or has actually suffered.\(^{16}\)

When the parties settle rather than litigate to judgment, the RCS rule could still be applied. This would result in an allocation of the costs of settlement between both parties, depending on whether the plaintiff settled for all or only a portion of what they originally sought.\(^{17}\) Thus, if the RCS rule were applied to these instances, parties would be deterred from filing suit at all if they were merely using the complaint to force the opponent to negotiate. Once the case is filed in court, then any outcome would result in payment (by one or both parties) of their costs to the court.

This segment of the administration of the rule is open to different interpretations, depending on what policy makers wish to

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\(^{16}\) This point should be emphasized in terms of the previously discussed assumption that the judicial system works correctly to determine winners and losers, or serves as an accurate backdrop for that determination.

\(^{17}\) Such an application of the RCS rule might encourage litigation and deter settlement since the costs of settling would be assessed against one or both parties. However, it is possible that the bargained result could also include a side agreement over the distribution of litigation costs, if the parties could agree on some arrangement.
achieve by the rule. If the rule is to deter litigation, then the rule should be applied to settlements if they are filed as cases. If the objective of the rule is to impose punishment on litigants who persist in a non-meritorious case, then RCS need not be applied to negotiated settlements that occur anytime before judgment, only to cases litigated to judgment.

Fourth, consideration must be given to the operation of the RCS rule when a trial outcome is appealed for alleged legal errors. One alternative is to adopt the position that each appeal is a separate legal proceeding with its own winning and losing parties. A party losing at the trial level, and at all appellate levels as well, would be subject to a sequence of separate penalties under RCS. Another alternative is to waive the RCS penalty for a party winning at any level. Here the presumption is that if a party prevails at any level, its case must have been sufficiently strong to render inappropriate the imposition of any additional penalties. It is difficult to determine at this preliminary stage of analysis of the RCS rule, whether the latter alternative would encourage or discourage appeals. On one hand a successful appeal could cancel any penalties, in addition to reversing the judgment, so a losing party would be encouraged to appeal. On the other hand, an unsuccessful appeal could further add to the losing party's expenses, perhaps magnifying the costs significantly, thus deterring some questionable appeals.

Finally, the payment of the penalties incurred by the losing side under RCS raises some issues which require further elaboration. In order for the RCS rule to operate in the intended manner, it is necessary that the losing party be capable of paying the mandated penalty. Unless the losing party is a prisoner or is represented by Legal-Aid, where an exception can be made, the fact that this party is indigent cannot be an excuse for failing to pay the RCS penalty. To ensure compliance with the RCS rule, each party could be required to present to the court prior to trial a detailed accounting of its expenses up to that point, along with a bond in the amount of those expenses. The additional expenses arising from the trial itself could be handled in a similar manner later. An additional benefit from having the courts be the recipients of the RCS penalty is that they have both the incentive and the enforcement power needed to ensure that the fine is actually paid.

An issue might then arise when the client is unable to post the required bond using his own resources. An example is an indigent plaintiff injured in a car accident suing the driver of the car and/or the driver's insurance company. In such a circumstance an arrangement would already have to be made between the plaintiff and lawyer to cover the legal expenses (a contingency-fee arrangement), even under the existing American rule. Under RCS, the ar-
rangement would then be extended to deal with the payment of any additional penalties mandated under the rule.

This naturally leads to the question of the role of contingency-fee schemes under the RCS rule. In a typical contingency-fee arrangement, a lawyer agrees to absorb all or part of the client's legal expenses in exchange for a percentage of any judgment won. Under RCS, this arrangement could be extended by having the lawyer agree to assume responsibility for any RCS penalties, in exchange for a higher percentage of the judgment. Guidelines for such arrangements could be specified by legislatures or by the appropriate bar regulators, and these would allow the introduction of the RCS rule to be accommodated within the framework of existing contingency practices.

Perhaps RCS could lessen the pressure to prohibit contingency-fee arrangements, which have become the targets of mounting criticism. This criticism has its origin in the perception that contingency fees encourage frivolous or nuisance lawsuits directed at large corporations, because these suits have some "value" to the client and attorney even when settled, rather than litigated. However, under RCS non-meritorious lawsuits would be discouraged whether or not contingency fees were allowed, and hence the desired end could be achieved through an alternate route. This obviates the need for reforming contingency-fee arrangements, which might be very hard to achieve. The implication of the European experience is that it may be difficult to eliminate the effects of contingency-fee practices, even if such arrangements were expressly forbidden, in the absence of a mechanism such as RCS which achieves the same result by other means.

Since an attorney may become responsible for his client's penalty under the RCS rule, one effect of this rule is to bundle the interests of attorneys and clients together. This is certainly contrary to the expectation that attorney services are independent of client interests, and that attorney independence is essential to the quality of the professional services rendered to clients. It is also counter to the professionalism of the practicing bar. However, the existing contingency-fee system does bundle lawyer and client interests in those cases de facto. It is an objective of the RCS rule to discourage various kinds of litigation, and this would include some cases where contingency-fee arrangements are prevalent, and others where this

19. See, e.g., Werner Pfennigstorf, The European Experience with Attorney Fee Shifting, 47 Law & Contemp. Probs. 37 (1984) (observing that although American-style contingency-fee arrangements are either prohibited or considered unethical in Europe, existing European rules can produce results that are very similar to those arising from a contingency arrangement).
fee arrangement may not be widespread. This rule may result in the reduction of contingency-fee usage if attorneys become financially responsible for their client's costs in lost cases.

This bundling of interests then recognizes the fact that financial and substantive interests of clients and attorneys are often joined by the current system. The question of whether such a connection of interests "should" occur is for legislatures to determine. For purposes of the present analysis, the party actually responsible for the RCS penalty is the loser, and may include the client, his attorney, an insurer, or some other third party.

The preceding discussion leads to the question of class-action suits. These can be accommodated within the framework of the RCS rule by defining the "winners" or "losers" as the parties whose names actually appear in the lawsuit. Since class-action litigation costs are usually borne by other parties, such as the law firms representing the plaintiffs and all the members of the class, whatever agreements cover the legal expenses could be extended to include possible RCS penalties, as in the case of contingency-fee arrangements.

Having outlined the RCS rule and discussed it in terms of its purpose and its operation, it becomes essential to examine the impact of this rule in formal terms. The next section explores this aspect of the rule by comparing its effects to those of the American and the European rules. This should permit a clear understanding of the differences and similarities of impact among these three rules.

III. Quantitative Results for the Reverse-Cost-Shifting Rule

Here a quantitative description of the reverse-cost-shifting rule is presented, and the operation of this rule is illustrated with several examples. The objective is to compare the effects of the RCS, American, and European rules on both the plaintiff and the defendant under a variety of circumstances. It will be shown specifically, in a simple but realistic cost model, that under RCS either plaintiff or defendant can be discouraged from litigating if the a priori probability of winning is less than some pre-assigned value. This section further demonstrates quantitatively that when a case actually goes to trial, the optimum strategy for each side under RCS is to limit its costs to those needed to present the essential core of its case, without resorting to unnecessary over-investment. These features of the RCS rule, as well as others previously mentioned, emerge from the results presented here.
This discussion of RCS begins by introducing a model that applies to a plaintiff \( \Pi \) suing a defendant \( \Delta \) for \( J \) dollars. Let \( G(x) \) represent the net amount of money (in dollars) that \( \Pi \) will gain (or lose) as a function of his expenditures which are denoted by \( x \). Under RCS \( G(x) \) is given by

\[
G(x) = SP(x) - \{x + Cx [1 - P(x)]\},
\]

where \( x = \) plaintiff's expenditures (in dollars)

\( P(x) = \) plaintiff's probability of winning as a function of \( x \)

\( S = \) sum (in dollars) plaintiff actually expects to receive if he wins (which may be different from \( J \)).

\( Cx = \) plaintiff's liability under RCS (in dollars)

Since \( P(x) \) denotes the a priori probability that \( \Pi \) wins as a function of \( x \), \( [1 - P(x)] \) is the probability that \( \Pi \) loses. The term \( SP(x) \) then represents the gain expected if \( \Pi \) wins an amount \( S \) with a probability \( P(x) \). This gain is offset by the losses appearing in curly brackets: These include \( \Pi \)'s direct expenditures \( x \) as well as the RCS penalty \( Cx \) which \( \Pi \) incurs with a probability \( [1 - P(x)] \). As demonstrated below, the "compensation factor" \( C \) can be chosen to ensure that suits with a low probability of being won lead to a negative \( G(x) \) for all \( x \). By implication such suits should not be litigated in the first place, since no expenditure \( x \) will lead to a net gain. The results for the American rule are recovered by setting \( C = 0 \). The European rule must be treated differently, as discussed in detail below.

---

20. The notation in the present paper differs from that used by most authors. This is primarily due to the fact that \( \Pi \)'s probability of winning is treated as a function which depends on his expenditure \( x \), hence the notation \( P(x) \). Similarly \( \Delta \)'s probability of winning is denoted by \( P(y) \), where \( y \) is his expenditure. \( P(x) \) will depend in turn on the quantities \( P_\pi \) and \( x \), which are defined in the text, and which have no counterparts in conventional analyses. The following Table compares the notation of the present paper and the conventional notation for various quantities. N/A indicates that the indicated quantity does not arise in the corresponding analysis.

<table>
<thead>
<tr>
<th>Definition</th>
<th>Conventional Symbol</th>
<th>Our Symbol</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \Pi )'s probability of winning</td>
<td>( P_{\Pi} )</td>
<td>( P(x) )</td>
</tr>
<tr>
<td>( \Pi )'s expected damages</td>
<td>( D_{\Pi} ) or ( J_{\Pi} )</td>
<td>( S )</td>
</tr>
<tr>
<td>( \Pi )'s litigation costs</td>
<td>( C_{\Pi} )</td>
<td>( x )</td>
</tr>
<tr>
<td>( \Pi )'s costs of settling</td>
<td>( S_{\Pi} )</td>
<td>N/A</td>
</tr>
<tr>
<td>( \Pi )'s limiting probability of winning</td>
<td>N/A</td>
<td>( P_{\pi} )</td>
</tr>
<tr>
<td>( \Delta )'s probability of winning</td>
<td>( P_{\Delta} ) or ( 1-P_{\Pi} )</td>
<td>( P(y) )</td>
</tr>
<tr>
<td>( \Delta )'s expected litigation loss</td>
<td>( D_{\Delta} ) or ( J_{\Delta} )</td>
<td>( S )</td>
</tr>
<tr>
<td>( \Delta )'s costs of litigating</td>
<td>( C_{\Delta} )</td>
<td>( y )</td>
</tr>
<tr>
<td>( \Delta )'s costs of settlement</td>
<td>( S_{\Delta} )</td>
<td>N/A</td>
</tr>
<tr>
<td>( \Delta )'s limiting probability of winning</td>
<td>N/A</td>
<td>( \bar{P}_{\pi} )</td>
</tr>
</tbody>
</table>
To complete the analytic model the functional form of $P(x)$ must be specified. In the real world the plaintiff’s probability of winning, $P(x)$, is likely to be a complicated function of his expenditures $x$ and other variables, but for present purposes the following simple parametrization of $P(x)$ will suffice:

$$P(x) = P_0 \frac{1}{1 - e^{-x/x_0}},$$  \hspace{1cm} (2)

where $P_0$ and $x_0$ are constants, and $e$ is the base of natural logarithms. The quantity $x_0$ is the amount that $\Pi$ must spend for $P(x)$ to reach 0.63 of $P_0$, where 0.63 = $1/e$ is a standard measure of an exponential decrease. The content of Equation (2) becomes more evident when we consider the two limiting cases,

$$x/x_0 << 1: P(x) \approx x(P_0/x_0),$$ \hspace{1cm} (3)

$$x/x_0 >> 1: P(x) = P_0.$$ \hspace{1cm} (4)

Equations (2)-(4) incorporate two simplifying assumptions about $P(x)$: For small $x$ the probability of winning increases linearly with $x$, whereas for large $x$, $P(x)$ approaches a limiting value denoted by $P_0$. The first assumption is reasonable, and assuming some other dependence for small $x$ (e.g. $x^2$) does not significantly affect the results. The second assumption incorporates the view that regardless how much $\Pi$ spends, his probability of winning will level out at a value $P_0$ which is determined by the objective facts in the case. (The fact that $P_0$ is not necessarily a 100% probability of winning must be emphasized.) This is again a plausible simplifying assumption which can easily be relaxed without materially affecting the stated conclusions. A plot of $P(x)$ is shown in Figure 1.

The content of Figure 1 can be illustrated as follows: Assume, as in the figure, that the “best case” probability of winning is 0.5 (i.e., 50%), and consider the curve with $x_0 = 1.0$. If the plaintiff’s expenditures $x$ are expressed, for example, in thousands of dollars then $x_0 = $1,000, and the graph for $x_0 = 1$ shows his probability of winning as a function of $x$. The figure then indicates that an expenditure of $2,000 leads to a 43% chance of winning, and an expenditure of $3,000 leads to a 48% chance of prevailing. However, increasing his expenditure to $4,000 (i.e. by 33%) only increases his probability of winning from 48% to 49%. The fact that the probability $P(x)$ eventually reaches a plateau for sufficiently large values of $x$, is an important feature of the present model. However, the specific functional form for $P(x)$ in Equation (2) is not critical, and another function which has a similar shape will lead to approximately the same results.

To plot $G(x)$ for various cases of interest it is helpful to rewrite Equation (1) in the form

$$G(x) = P(x)(S+Cx)-(C+1)x.$$ \hspace{1cm} (5)

When combined with Equation (2), $G(x)$ expresses the net gain (or loss) expected by the plaintiff as a function of his expenditure $x$, and
The probability function $P(x)$. $P_\text{m}$ is the limiting probability and $x_0$ is the expenditure needed for $P(x)$ to reach 63% of $P_\text{m}$. The figure is drawn for $P_\text{m} = 0.5$ and $x_0 = \frac{1}{4}, \frac{1}{2}, 1, 4$ (in units of dollars). This figure indicates that a smaller value of $x_0$ requires a smaller expenditure in order for $P(x)$ to reach 63% of its maximum value, which here is $P_\text{m} = 0.5$.

Figure 1: The probability function $P(x)$. $P_\text{m}$ is the limiting probability and $x_0$ is the expenditure needed for $P(x)$ to reach 63% of $P_\text{m}$. The figure is drawn for $P_\text{m} = 0.5$ and $x_0 = \frac{1}{4}, \frac{1}{2}, 1, 4$ (in units of dollars). This figure indicates that a smaller value of $x_0$ requires a smaller expenditure in order for $P(x)$ to reach 63% of its maximum value, which here is $P_\text{m} = 0.5$.

The four input parameters $S$, $C$, $P_\text{m}$, and $x_0$. Of these, $C$ is obviously known, being determined by statute. $S$, $P_\text{m}$, and $x_0$ are more difficult to determine, depending as they do on the details of each case. In practice $P_\text{m}$ could be identified with the “best-case” probability of winning under the condition that the plaintiff can spend an unlimited (or “infinite”) amount of money. $S$, $P_\text{m}$, and $x_0$ will depend on numerous factors, such as earlier precedents with similar cases, but for present purposes a presumption is made that these parameters can be estimated by the plaintiff and his attorney.

As previously noted, the American rule can be viewed as a special case of RCS in which the compensation factor $C$ is set to zero. By contrast, the European rule must be treated separately, since under the European rule the anticipated gain (or loss) for each side depends on the expenditures of the other party.

The plaintiff’s gain function $G_E(x)$ under the European rule is then given by

$$G_E(x) = (S+x)P(x) - [x+y \{1-P(x)\}].$$

(6)

The term $(S+x)P(x)$ represents the expected gain arising (with probability $P(x)$) from the sum of the judgment $S$ that the plaintiff receives and his recovered expenditures $x$. (The latter contribution is, of course, not present in either the RCS or American rules.) The
terms in curly brackets, which enter with an overall negative sign, represent the loss contributions to $G_E(x)$. These include $\Pi$'s own expenditures $x$, as well as his obligation to reimburse $\Delta$'s expenses $y$, which he does with probability $[1-P(x)]$. The presence in $\Pi$'s gain function $G_E(x)$ of a term proportional to $\Delta$'s expenditures $y$ is what distinguishes the formal analysis of the European rule from the analysis of both the RCS and American rules. Since $\Delta$'s expenditure $y$ is not under the control of $\Pi$, $G_E(x)$ must be computed for a range of values of $y$, as shown in the accompanying figures.

Figures 2, 3, and 4 exhibit $G(x)$ and $G_E(x)$ for various assumed values of the parameters. $S$ has been arbitrarily set at $S = 10$, and it has been further assumed that $x_o = 1$ which fixes $x_o/S$ at a reasonable value 0.1. In terms of the example presented in analyzing Figure 1, $S = 10$ corresponds to a plaintiff expecting to receive $10,000, and $x_o = 1$ means that an assumption has been made that the plaintiff must spend $1,000 to have a 63% chance of reaching his limiting probability $P_\alpha$. As previously noted, $P_\alpha$ will depend in turn on the details of the specific case, and on other factors such as previous court decisions. For present purposes, exhibited below are the re-

![Plaintiff's Analysis (Limiting Probability = 0.8)](image)

**Figure 2:** The plaintiff's gain function $G(x)$ for $P_\alpha = 0.8$, under the RCS, American, and European rules. This figure, and all the remaining results, assume $S = 10$, $x_o = 1$ and $C = 1$. Note that the results for $G(x)$ under RCS are very similar to those arising from the existing American rule. The results for the European rule are shown for different assumed values of the defendant's expenditure $y$. See text for further details.
results for three representative situations, $P_\text{m} = 0.8$, $P_\text{m} = 0.5$, and $P_\text{m} = 0.2$.

For the European rule, the results for four values of $y$ have been exhibited. Figure 2 indicates that the results for $G(x)$ under the RCS rule are very similar to those that obtain under the existing American rule when $P_\text{m} = 0.8$. This reflects the important feature of the RCS rule that its consequences differ little from those of the American rule when $\Pi$ has a strong case (i.e., where the a priori probability of losing is small.) Note that under both rules $G(x)$ becomes negative as $x$ approaches $S$ (here set at 10), since for $x > 10$, $\Pi$'s expenditures would exceed his return should he win.

The results for the RCS and American rules are significantly different from those of the European rule when $P_\text{m} = 0.8$. Figure 2 shows that there is no expenditure $x$ in the indicated range for which $G_E(x)$ becomes negative under the European rule. (However, $G_E(x)$ can become negative for sufficiently large $x$.) This means that, for the assumed parameters, the European plaintiff has little incentive to restrict his own spending, in contrast to what obtains under either the RCS or American rules. Moreover, these results indicate a feature that is common to all of the figures, namely, that RCS provides the strongest disincentive for the plaintiff (or defendant) to over-invest in his case. This can be seen in Figure 2 by noting that for a given set of parameters (i.e., a given curve), the optimum expenditure $x$ corresponds to the peak in each curve. This peak typically occurs at the smallest value of $x$ for RCS, since only under RCS is the penalty for losing based on each party's own expenditures. This is seen most clearly in Figure 3, which compares the different rules for the circumstance where the limiting probability $P_\text{m}$ is 0.5. This figure shows that the peak of $G(x)$ occurs at the smallest values of $x$ for RCS, followed in turn by the American and European rules. Note that when $\Pi$'s limiting probability is 0.5, the European rule encourages a higher optimum investment by $\Pi$, compared to the RCS and American rules.

The differences among the American, RCS, and European rules emerge most clearly when the limiting probability $P_\text{m}$ is small. This is shown in Figure 4 for the case $P_\text{m} = 0.2$, with all other parameters having the same values as before. Consider first a comparison of the RCS and American results. The figure indicates that even when $P_\text{m}$ is as small as 0.2, under the American rule $G(x)$ remains positive for $x < 1.6$. This means that it would pay for the plaintiff to litigate such a case, provided that he kept his expenses low. By contrast, under the RCS rule (with $C = 1$) $G(x)$ is always negative (for all values of $x$). It follows that under the RCS rule, cases where $P_\text{m}$ is 0.2 (or less) would never be filed since no expenditure $x$ would likely lead to a net positive return. The RCS rule thus operates to remove from the system cases for which $P_\text{m}$ is below some threshold value,
FIGURE 3: The plaintiff's gain function $G(x)$ for $P_r = 0.5$. See caption to Figure 2 for further details.

FIGURE 4: The plaintiff's gain function $G(x)$ for $P_r = 0.2$. Notice that under RCS, $G(x)$ is negative for all $x$. It follows that under RCS no expenditure $x$ would likely lead to a positive return, and hence such cases should not be filed in the first place. By contrast, a net positive gain is possible under the American rule. For a discussion of the European rule, see text and caption to Figure 2.
by ensuring that \( G(x) < 0 \). This threshold value can be controlled by
an appropriate statutory choice of \( C \).

The differences among the RCS, American, and European rules can be illustrated in another way by continuing the previous example in which \( \Pi \) is suing \( \Delta \) for \$10,000. Figure 4 indicates that even when \( \Pi \)'s limiting (i.e. "best case") probability is as low as 0.2 (20%), it pays for him to litigate under the American rule. In fact \( \Pi \)'s optimum strategy, corresponding to the peak in the top curve of Figure 4, is to invest \$690 in his case which will then led to a net gain of \$310. (In terms of the graph, under the American rule the maximum value of \( G(x) \) is 0.31 which occurs at \( x = 0.69 \).) In contrast, the results for RCS using the same assumptions, with \( C=1 \) set by statute, indicate that \( G(x) \) is negative for all values of \( x \). This means that \( \Pi \) would experience a net loss regardless of what he spent, which loss would increase the greater his expenditure. In practice this would mean that any case in which the limiting probability was 20% or less would simply not be filed, and hence all such cases would be removed from the courts under RCS.

Figure 4 also clearly demonstrates the differences between the RCS and European rules. The graphs show that \( G_E(x) \) is negative for most values of \( x \) and \( y \) under the European rule, and so the plaintiff would presumably be discouraged from filing such a suit in the first place, just as he would under RCS. However, if such a suit were filed (for some non-monetary reason), the optimum \( \Pi \) strategy under the European rule would be to invest the amount \( y \) corresponding to the peak of each curve, whereas under RCS the optimum strategy would be to invest nothing at all. This point is again discussed below when the defendant's strategies are compared under the different rules.

Figures 5 and 6 demonstrate how the choice of \( C \) influences which cases are effectively removed from the court system. Figure 5 indicates that with \( C = 1 \) cases with \( P_\pi = 0.2 \) or less would result in \( G(x) \) being negative for any expenditure \( x \), as already noted. For \( P_\pi = 0.3 \) or greater, \( G(x) \) would be positive for some values of \( x \) but, given the uncertainties in estimates of \( P_\pi \), filing a case with \( P_\pi = 0.3 \) would not be recommended. Figure 5 also indicates that for larger values of \( P_\pi \) an appropriate investment in such a case could be worthwhile. Figure 6 suggests similar conclusions when \( P_\pi \) is fixed and \( C \) is allowed to vary. The larger the value of \( C \) (for a given \( P_\pi \)), the less the plaintiff can invest before \( G(x) \) becomes negative.

Next the RCS, American, and European rules are analyzed from the point of view of the defendant \( \Delta \). To avoid notational confusion, \( \Delta \)'s expenditures are denoted by \( y \), and his probability of winning by \( \tilde{P}(y) \),

\[
\tilde{P}(y) = \tilde{P}_\pi(1-e^{-x/y_0}),
\]
Figure 5: Plot of $G(x)$ as a function of $x$ for different choices of the limiting probability $P_\infty$, which is denoted by $P$ in the legend. The graphs are drawn for $C=1$. As noted in the text, $G(x)$ is always negative when $P_\infty$ is 0.2 or less and hence such cases would never be filed under the RCS rule.

Figure 6: Plot of $G(x)$ as a function of $x$ for different choices of the compensation factor $C$. For $P_\infty$ fixed at the value 0.5, a larger compensation factor encourages a smaller optimum investment $x$, corresponding to the peak of each curve.
where,
\[ \hat{P}_w = \text{defendant's limiting probability of winning} \]
\[ y_o = \text{expenditure (in dollars) required to achieve 63% of } \hat{P}_w \]
Since \( P(x) \) and \( \hat{P}(y) \) are being evaluated separately by H and A, it is not necessarily the case that \( [P(x) + \hat{P}(y)] = 1 \), or even that \( [P_w + \hat{P}_w] = 1 \), as might naively be expected. If \( P(x) \) and \( \hat{P}(y) \) were being estimated simultaneously by a disinterested third party, then one could reasonably impose the constraint that the sum of the probabilities for \( \Pi \) and \( \Delta \) winning is 100% (i.e., 1.0). However, this is not the situation contemplated here. Similarly, the defendant is free to assume that if he were to lose, the judgment against him would be an amount \( S \) which is not necessarily the same as either the amount \( J \) being asked by the plaintiff, or the amount \( S \) that the plaintiff actually expects to receive.

The functional dependence of \( \hat{G}(y) \) on \( y \) can be obtained following the analogous discussion for \( G(x) \). Since \( \Delta \) gains nothing if he wins, the analog of Equation (1) for \( \Delta \) is
\[ \hat{G}(y) = -y-(Cy+S)[1-\hat{P}(y)] = \{(\hat{S}+Cy)\hat{P}(y)-(C+1)y\}+S. \]
(8)
The first part of Equation (8) incorporates the statement that \( \Delta \) must pay out not only his expenses \( y \), but also the sum of the judgment \( \hat{S} \) and the RCS penalty \( Cy \) if he loses, which he does with probability \([1-\hat{P}(y)]\). Note that \( \hat{G}(y) \) is always negative, so the best that \( \Delta \) can achieve is to minimize his expected losses. Since the expression in curly brackets in Equation (8) has the same functional form as for \( G(x) \) in Equation (5), \( \Delta \)'s results can be obtained from \( \Pi \)'s results by shifting the latter down (i.e., subtracting) the amount \( \hat{S} \). The resulting graphs are shown in Figures 7, 8, and 9. Figure 9 indicates that for \( C = 1 \) and \( \hat{P}_w = 0.2 \) any expenditure of funds merely increases the defendant's losses, so he would presumably settle without litigating. By contrast, under the American rule, the expenditure of a small amount of money would be justified, notwithstanding the very low probability of success.

These results can again be illustrated by continuing the same example being considered. Suppose that \( \Pi \) and \( \Delta \) agree that the amount in dispute is $10,000, and that \( \Delta \) has only a 20% chance of prevailing at trial. As noted above, under RCS \( \Delta \) would have a strong incentive to not litigate. This is not the case under the American rule. Figure 9 indicates that \( \Delta \)'s optimum strategy (corresponding to the peak of the top curve) is to invest $690 in his defense, in which case his losses would be cut from $10,000 to $9,690. The RCS rule allows society to discourage such a strategy in the interest of not burdening the courts with such "one-sided" cases.

The defendant's gain function \( \hat{G}(y) \) under the European rule can be written down by following the discussion leading to Equation (6), and the result is
\[ \hat{G}(y) = y\hat{P}(y)-[y+[1-\hat{P}(y)](\hat{S}+x)]. \]
(9)
The first term represents the recovery of A's expenses y if he wins, which he does with probability $P(y)$. The losses include A's expenses y, along with the sum of the judgment $S$ and $\Pi$'s expenses x, which A is liable for with probability $[1-P(y)]$. For computational purposes it is convenient to rewrite Equation (9) in the form

$$\tilde{G}_e(y) = -(S+x+y)[1-P(y)].$$

(10)

The results for the European rule are shown along with those of the RCS and American rules in Figures 7, 8, and 9. The results for the defendant's analysis mirror those for the plaintiff's analysis, with one notable exception: Since the decision to litigate belongs to $\Pi$ and not $\Delta$, the defendant has no alternative but to choose the optimum strategy dictated by the appropriate curve in Figures 7-9. When $P_\pi = 0.2$, depicted in Figure 9, $\Pi$'s decision to litigate not only forces $\Delta$ to invest in his case, but ensures that he will on average lose more than he would under RCS. As already noted, $\Delta$'s optimum strategy under RCS would be to settle without litigating, which is not the case for the European rule.

This formal discussion illustrates the effect of the RCS rule in comparison with the existing American and European rules. It also indicates the type of impact this proposal might have on litigation decisions in situations where the other two rules would produce different outcomes. The discussion in the next section presents a more detailed qualitative comparison of the RCS, American, and Euro-
Defendant's Analysis (Limiting Probability = 0.5)

FIGURE 8: The defendant's gain function $\tilde{G}(y)$ for $\bar{P}_\omega = 0.5$. See caption to Figure 7 for further details.

Defendant's Analysis (Limiting Probability = 0.2)

FIGURE 9: The defendant's gain function $\tilde{G}(y)$ for $\bar{P}_\omega = 0.2$. Note that under RCS the defendant's optimum strategy is to settle without investing at all in his case. By contrast, under both the American and European rules some investment would be encouraged.
pean rules from the perspective of various issues that arise when
cost allocation rules are debated.

IV. COMPARISON OF COST ALLOCATION RULES

This section discusses a comparison of the RCS, American, and
European rules for cost shifting (i.e., for allocating legal expenses).
One way of framing this comparison is to ask whether there exists
(even in principle) an “ideal” allocation system. This question is
necessarily vague, since “ideal” is an imprecise term. Nevertheless,
a set of characteristics that such a system might embody is pro-
posed, and then the question is asked whether any of the three allo-
cation systems incorporates all of these features. The following
discussion exhibits a collection of such criteria which, although not
exhaustive, are sufficient to support the conjecture that an ideal
cost allocation system may not exist. The criteria for such a system
are outlined below.

1) The “winning” party should be made “whole”.

This is one of the principal justifications for the European rule.
However, the European rule is hard to justify when a case arises
from a good faith mutual disagreement, when the courts them-
selves are divided on a point of view, or when the outcome would
have been difficult to predict, as in sui generis cases. Since both
parties in such cases can claim to be acting in good faith, there is
little justification for levying an additional penalty (i.e. on top of the
judgment itself) against the loser. Hence this criterion, although
reasonable, is no more compelling than the others presented below.

2) Frivolous or vexatious actions should be discouraged.

This would seem to be self-evident, except that what is “frivo-
los” to one party may be justified to the opponent. However, under-
lying all allocation rules is the assumption that each party can
calculate within reason how an objective third party (e.g. a jury)
would view the strengths and weaknesses of each side’s case, even
if the actual damages and liability cannot be determined objectively
in advance by the parties.

3) Large disparities in the resources of the opposing parties
should not lead to unequal justice.

This is part of the rationale for the American rule. It reflects
the view that all parties should have equal access to the courts re-
gardless of their economic circumstances. This criterion can be
summarized by the notion that the courts should attempt to “level
the playing field” for the opposing parties. The European rule is an
example of an “uneven playing field,” since the threat of having to
pay the legal fees of a party with substantial resources can deter a

smaller party from pursuing its case, even when that case is meritori-
ous. Both the American and RCS rules are attempts to "level the
playing field," relative to what would obtain under the European
rule.\textsuperscript{22}

4) **Opposing parties should be deterred from engaging in excess
investment.**

This is one of the rationales for the reverse-cost-shifting propo-
sal. An "excess" could be defined as an effort or expenditure which
does not materially increase the gain function $G(x)$ or $G(y)$ for the
plaintiff or defendant respectively. Moreover, parties should be en-
couraged to expedite litigation to reduce both the cost and time in-
volved. This objective can be viewed as important to conserving
society's (as well as litigants') resources.

5) **The courts should be supported by those who use them.**

This is another rationale for the reverse-cost-shifting proposal.
Just as other public services, such as the state motor vehicle bu-
reau, are at least partially self-supporting, so should the courts be,
至少 for civil actions. It should be noted that there is an alter-
mate view, which holds that the courts are a service whose decisions
benefit all of society, not just the litigants themselves. On this view
the courts should be funded by general tax revenues. In reality,
courts can be (and are) funded by both taxes and payments of vari-
ous sorts by individual parties.\textsuperscript{23}

6) **Out-of-court settlements should be encouraged.**

Since litigation raises the cost of settling a case, which cost is
ultimately borne by society as a whole, it is preferable that cases be
settled out of court. This conserves various resources both of the
parties and of society.

7) **Cost allocation rules should strive for judicial consistency
and predictability.**

One of the objections to the European rule is the arbitrariness
in deciding which expenses of the winning party should be paid by
the losing side. By contrast, under reverse cost shifting each side's
exposure is known since it is determined by their own expenses.

8) **Socially useful litigation should be encouraged.**

This incorporates the idea of the "private attorney general."\textsuperscript{24}
Of course, it is often difficult to determine at the time a lawsuit is
instituted which cases warrant being included in this category, or
who should make such a determination. However, such generally


\textsuperscript{23} The literature relating to adjudication and the settlement of disputes in public and private good contexts is presented in a Seminar by Henry G. Manne, *Private Alternatives to the Judicial Process*, 8 J. LEGAL STUD. 231 (1979).

beneficial litigation might be recognized and rewarded in some manner.

The entries in Table I for criteria 1 and 2 are obvious, where it is understood that the entry for the American rule in 2 indicates that there is no *additional* "penalty" beyond the litigant's own direct costs. For criterion 3, the entry under the European rule reflects what would obtain in the absence of provisions which waive the European rule in special circumstances, *e.g.*, for individuals suing large corporations. The rule can sometimes be waived at the discretion of the trial judge, which is the origin of the entry for criterion 7. The entries for criterion 4 reflect the *additional* disincentive arising from RCS, over and above the obvious desire of each party to minimize its own costs. The entries for criterion 5 are obvious, since only RCS provides for a systematic mechanism under which the users support the courts. The entries under criterion 6 relate to the *additional* incentive to settle provided under both the European and RCS rules by the imposition of their respective penalties. Criterion 7 deals with the issue of consistency with respect to the imposition of penalties for court costs. Under both the American and RCS rules, the obligations of the losing parties are clear. In contrast, the losing party's obligations under the European rule are less clear, since further court proceedings may be necessary to determine the actual assessment against the losing party. The entry under the American rule for criterion 8 is not to suggest that litigation is actually encouraged, as much as to suggest that it is not discouraged in comparison to the European and RCS rules.

**Table I. Comparison of cost-shifting rules**

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. winner made &quot;whole&quot;</td>
<td>American</td>
</tr>
<tr>
<td>2. frivolous actions discouraged</td>
<td>NO</td>
</tr>
<tr>
<td>3. &quot;level playing field&quot;</td>
<td>YES</td>
</tr>
<tr>
<td>4. discourage excess investment</td>
<td>NO</td>
</tr>
<tr>
<td>6. settlements encouraged</td>
<td>NO</td>
</tr>
<tr>
<td>7. judicial consistency*</td>
<td>YES</td>
</tr>
<tr>
<td>8. encourage &quot;socially useful&quot; litigation</td>
<td>YESb</td>
</tr>
</tbody>
</table>

For each of the criteria described in the text, YES indicates that it is embodied in the corresponding rule and NO indicates that it is not. See text for further discussion.

b See text for further discussion.

None of the three rules achieves all of the criteria outlined above. This is in part a consequence of the fact that these criteria are actually mutually exclusive. For example, consider what would
happen under RCS2 where the loser would pay the winner rather than the court. On the one hand RCS2 would achieve criterion 1, which is not the case under the RCS rule as formulated. In this version of the rule the winning party would recover at least some of its expenditures (and perhaps more than it actually spent). However, RCS2 is incompatible with both criteria 4 and 5, contrary to what obtains under the RCS formulation. The failure to satisfy 5 is obvious, and 4 would be compromised by the "windfall" problem discussed in Section II.

Although one cannot exclude the possibility that another cost allocating rule might achieve all of these criteria, Table I and the preceding discussion of RCS2 suggest that this is unlikely. The situation with respect to cost allocation rules might then be similar to that for voting systems, which have been shown by Arrow's analysis\textsuperscript{25} to be plagued by various undesirable features. Since none of the existing or proposed cost allocation rules is "ideal," the best alternative is the one with the most desirable features (or the fewest undesirable ones). In this sense, Table I suggests that RCS may be a viable alternative to the American and European rules. Moreover, since the compensation factor $C$ can be adjusted incrementally over a period of years by policy makers, RCS could be phased in over a sufficiently long period to ensure a smooth transition from the existing American rule to RCS. Additionally, by appropriately choosing $C$, RCS could become a valuable policy mechanism for controlling the flow of litigation into American courts.

V. CONCLUSIONS

Allocation rules which deal with attorneys' fees and other litigation costs have a direct impact on society, the judicial system, and the litigants themselves. This analysis develops an alternative cost allocation rule, reverse-cost-shifting (RCS), and systematically compares this rule with the American and European rules. In the simplest of terms the effect of RCS is to "tilt the legal playing field" in favor of the party that has the more legitimate (stronger) case. This is achieved by penalizing the losing party both for bringing (or defending) a weak case, and for overinvesting in that case. It is important to emphasize that in favoring the party with the stronger case, it is immaterial whether that party is the plaintiff or defendant, or whether the party is big or small in size or in resources. Thus, an individual bringing a legitimate product liability suit against a corporation would be significantly better off under RCS than under the existing American rule, since RCS would provide a disincentive for the corporation to defend or drag out the case. Of

\textsuperscript{25} Kenneth Arrow, Social Choice and Individual Value (2d ed. 1951).
course, the reverse would be true if the individual were bringing a non-meritorious case against the same corporation.

The choice among different rules should depend on a number of factors which include the objective of each rule, its impact, and its operation. While other authors have addressed these issues for the American and European rules, the focus of this article has been on the RCS rule and its impact. This rule is designed to produce two different and important results. First, it will reduce the amount of litigation that could be characterized as marginal, i.e., where a litigant has little chance of prevailing even with the investment of substantial resources. Thus the RCS rule might remove from the court system a portion of its current workload that does not serve a public good or produce other system-wide benefits. Second, the penalty paid by the losing party supports the court system itself, instead of reimbursing the prevailing party. By having the court become the recipient of the RCS penalty, not only is the "windfall" problem discussed in Section II solved, but it is also ensured that the users of the courts help support their operation.

In addition to presenting the RCS rule for allocating litigation costs, this analysis has provided a systematic comparison of the effects of all three allocation rules. The European rule encourages the litigation of strong claims, but clearly discourages litigating weak ones. The RCS rule provides similar incentives and disincentives for litigating. In addition, it provides the strongest disincentives for a party over-investing in its case. Among the three rules, the American rule is most likely to encourage litigation when the litigant lacks a clear or realistic chance of winning.

The three rules are also quite different from the point of view of their operation or administration. While the American rule requires no implementation, since each party simply absorbs its own costs, the European rule can be quite cumbersome to administer. It is riddled with exceptions and often requires secondary proceedings to determine and assess reasonable costs on the loser. The RCS rule has several attractive features including the capability of being implemented gradually by increasing the compensation factor \( C \) over a period of years. In addition, the RCS rule is compatible with existing practices relating to contingency-fee arrangements. Yet, at the same time, RCS works in the direction of discouraging some types of lawsuits that would otherwise be encouraged by such arrangements. The structure and formulation of the RCS rule would allow legislatures to apply the rule in selected areas, to set \( C \) at different values in appropriate situations, and to adjust the rule

from time-to-time to achieve the desired results. The flexibility of RCS, and its deterrent effects on litigation, suggest that the RCS rule may be a viable alternative to both the American and European rules.

This article concludes by briefly considering the likely economic impact of RCS were it to be enacted into law. As previously noted, the aim of RCS is to reduce both the number of lawsuits filed and the cost of each one. It is then fair to suppose that one effect of RCS would be to reduce the aggregate annual expenditure on litigation compared to what exists at present, and to thus curb what has been termed the "litigation explosion."27 Since RCS is completely neutral with respect to its impact on plaintiffs and defendants, and with respect to big and small parties, this reduction in litigation expenditure could be achieved in an evenhanded way. RCS would thus encourage the law industry to join other sectors of society such as the medical profession, private industry, government, universities, and the defense industry, in working to increase efficiency and to reduce unnecessary costs.