Regulating the Content and Volume of Litigation

An Economic Analysis

George L. Priest

35th Year

Rand

THE INSTITUTE FOR CIVIL JUSTICE

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THE
INSTITUTE FOR
CIVIL JUSTICE

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Foreword

The rules that determine who pays the attorney fees and other overhead costs incurred by the parties to a lawsuit are more and more frequently viewed as levers for enlarging or shrinking the flow of litigation. Abandoning the traditional American rule that each party bears his or her own costs, both courts and legislatures have increasingly sought to use cost-shifting as a tool for altering the behavior of litigants to achieve particular social policy objectives.

This tendency is easy to understand. The leverage potential of the heavy and fast-growing costs involved in bringing or defending a civil suit would seem to be very great. One can easily imagine a plaintiff or a defendant thinking twice about a suit if faced with the real possibility that either party could be required to pay the other's costs in addition to any judgment rendered.

But is the direction of the leverage effect predictable? Does it turn out, for example, that cost-shifting measures designed to reduce the incentives to litigate actually have that effect? Or does such shifting actually increase the incentives to bring or to prolong lawsuits?

And what about the situation where the lever is being applied in both directions at the same time? For example, when we decide that certain types of litigation should be encouraged—as in the case of action to vindicate civil or consumer rights—we enact a rule giving a winning plaintiff the power to force the defendant to pay the costs of bringing the suit. On the other hand, when we recoil in horror at the flood of lawsuits that clog many courts, we try to discourage all litigation by imposing a rule that gives a defendant who has offered to make a dollar settlement the right to force a plaintiff who rejects that offer to pay the costs of defending the action if the judgment awarded by the court turns out to be less than the offer.

What happens when these conflicting incentives collide? Can a defendant who has made a very modest offer and then won a civil rights case force a losing plaintiff to pay the costs of defending the

case? If not, why not? What options are available to make the conflicting incentives compatible?

This research addresses each of these questions in turn, developing an analytic technique for thinking them through then using it to examine the recent attempt by the U.S. Supreme Court to unravel the conflict issue. But the significance of both the method and the conclusions far transcends any particular case. Both go to the core of the effort to employ this tempting social policy lever. Those who would pull it would do well to ponder first the implications discussed herein.

The article is the result of work sponsored by the Institute, and is the latest in the Institute's series of reprints. The original publisher was the *Supreme Court Economic Review,* Volume 1, 1982, pp. 163–183. We offer this additional form of dissemination because of the unusually great utility that we believe the work offers for the many legislators and judges now wrestling with this tough set of issues.

Gustave H. Shubert
Director, The Institute for Civil Justice

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REGULATING THE CONTENT AND VOLUME OF LITIGATION: AN ECONOMIC ANALYSIS*

George L. Priest**

In recent years, courts and legislatures have used rules that shift liability for court costs and attorneys' fees to plaintiffs or defendants to achieve two different objectives: to encourage litigation by particular plaintiffs (in civil rights, pollution, and consumer litigation), and to regulate the volume of litigation (most commonly to encourage settlement). These goals are contradictory and in conflict in a recent Supreme Court case, Delta Air Lines, Inc. v. August. *This essay discusses the distributive effects of these rules and their effects on the rate of litigation. The analysis expands other recent treatments by considering offer-of-judgment rules and the parties' strategic actions.*

The attempt to regulate the content and volume of litigation by altering the assignment of costs and fees is an important aspect of modern judicial administration. In most American jurisdictions, each party traditionally bears its own litigation costs, win or lose. But in recent years, various statutes and procedural rules have shifted this separate responsibility for litigation and court costs to achieve two separate objectives. First, certain special statutes have empowered winning plaintiffs suing under them to recover litigation costs. In general, litigation costs have been shifted in this manner by statutes that simultaneously create rights of action for plaintiffs viewed as underprivileged relative to the defendants they are suing: examples include suits brought under Title VII of the Civil Rights Act of 1964,[1] under the Fair Housing Act,[2] or under the Magnuson-Moss Consumer Warranty Act.[3] Making defendants liable for the winning plaintiff's litigation charges is designed to encourage litigation by such plaintiffs, litigation thought to be deterred if plaintiffs must pay their own charges.

The second objective of shifting litigation costs is much different. Recently, there has been widespread concern over the volume of trial court litigation and the consequent delay in the administration of justice. The courts of virtually every state and most major metropolitan areas have instituted procedures to reduce the trial docket. These procedures include arbitration and settlement programs as well as procedural amendments, such as restricting pleadings or constraining discovery.[4] One instrument thought to encourage settlement is the shift of litigation

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costs. For example, procedural rules in many states,[5] as well as Rule 68[6] of the Federal Rules of Civil Procedure, provide that if a plaintiff rejects the defendant's formal settlement offer, and if the judgment ultimately received is less favorable to the plaintiff than the offer had been, then the plaintiff must reimburse the costs that the defendant incurred after submission of the offer.[7] Such rules are believed to encourage settlement by making more adverse the consequences to the plaintiff of rejecting the defendant's offer and litigating the case.[8]

These two ways in which the shift of litigation costs alters the content and volume of litigation appear contradictory, however. The first seeks to encourage litigation of a particular sort; the second, to discourage litigation generally. The Supreme Court in the 1980 Term faced this conflict in *Delta Air Lines, Inc. v. August.*[9] The plaintiff August, claiming racial discrimination under Title VII of the Civil Rights Act of 1964, rejected a formal settlement offer from Delta, but subsequently lost the case on the merits. Had she won the case, she could have recovered her litigation expenses from Delta under the Civil Rights Attorneys' Fees Awards Act.[10] But by rejecting the settlement offer and ultimately losing the case, August was, according to Delta, obliged to reimburse Delta for its litigation expenses under Federal Rule of Civil Procedure 68.[11] The lower courts denied Delta reimbursement, which decisions it appealed.[12] Thus, the Supreme Court confronted a contradiction between a rule that it had promulgated to deter litigation and a civil rights plaintiff whose legal action the members of Congress had clearly and explicitly tried to encourage. The Supreme Court acknowledged the virtues of Rule 68 in discouraging litigation, but by a labored construction of the history and language of Rule 68, it interpreted the rule so as to deny Delta recovery of its costs.

The Supreme Court's solicitude for civil rights plaintiffs is hardly surprising. But the Court's analysis of the apparent conflict in *August* over the use of attorneys' fees as instruments of litigation control contains an unusual feature. The Court seemed to regard the issues in *August* as presenting a dilemma between the goals of reducing litigation and of facilitating the vindication of civil rights. But in terms of incentives to settle or litigate, there is no contradiction between awarding attorneys' fees to prevailing civil rights plaintiffs and charging attorneys' fees to losing plaintiffs. Simple and straightforward economic analysis shows that under very basic conditions, both measures will encourage litigation and both will discourage settlement. The effect of charging the defendant's litigation costs to *winning* plaintiffs, as Rule 68 does, can be more ambiguous, although this procedure, too, is likely to encourage litigation compared with a procedure that requires each party to bear its own costs.

The different fee assignments have substantially contradictory distributive effects on the parties subject to them, however. One encourages litigation while enhancing the relative position of plaintiffs; the other encourages litigation while enhancing the relative position of defendants.

Thus, these assignments create changes in incentives to litigate and alter distributive gains and losses to plaintiffs and defendants. And, these changes and alterations conflict with one another in more complex ways than the Supreme Court realized. Although the Court thought in *August,* that it was sacrificing its goal of reducing litigation to preserve fairness between the parties, its decision, however confusing on the merits, is likely both to reduce litigation and to enhance the position of civil rights plaintiffs.

Efforts to reduce litigation will become more intense and extend to new methods of procedural amendment in the coming years. Hence, it is useful to analyze carefully the separate allocative and distributive effects of reform. In this respect, the Supreme Court's and the litigants' confusions in *August* are instructive. Section I of this essay shows how rules awarding certain victorious plaintiffs litigation costs against defendants both encourage litigation and enhance the relative position of plaintiffs. Section II demonstrates how rules awarding winning defendants litigation costs against losing plaintiffs also encourage litigation, but enhance the relative position of defendants.[13] Finally, Section III returns to *August* to observe how the Supreme Court's confusion over the determinants of litigation and settlement led it to misunderstand the effects of the two rules on litigation rates and on the relative positions of plaintiff and defendant.

I. FEES TO FAVORED PLAINTIFFS: INCENTIVE EFFECTS AND DISTRIBUTIVE EFFECTS

A. The American Rule

Most jurisdictions in the United States require litigants to pay their own litigation charges.[14] Thus, it is appropriate to evaluate the effects of the various alternative fee assignments relative to this base. According to the standard economic model of litigation,[15] the principal determinants of the parties' decision to settle or litigate a dispute are the amount at stake to the parties, their subjective estimates of success at trial, and their litigation and settlement costs. Settlement negotiations will fail, and litigation will ensue, if the plaintiff's minimum demand exceeds the defendant's maximum offer. One can express this condition by defining P_p and P_d as the plaintiff's and defendant's respective estimates of the plaintiff's chance of success at trial; J as the amount at stake in the dispute; C_p and C_d as the respective litigation costs; and S_p and S_d as the respective settlement costs. Thus, the plaintiff's minimum demand is $P_pJ - C_p + S_p$, and the defendant's maximum offer is $P_dJ + C_d - S_d$. The parties will litigate rather than settle if

(1) $P_pJ - C_p + S_p > P_dJ + C_d - S_d$.[16]

We can rearrange this inequality to show that litigation will occur if the difference in the parties' expectations of success times the judgment exceeds the difference between litigation and settlement costs:

(2) $(P_p - P_d)J > (C_p + C_d) - (S_p + S_d)$.

B. The Effect of Awarding Litigation Charges on the Rate of Litigation

How will requiring the losing defendant to pay the plaintiff's litigation costs affect the litigation-settlement rate?[17] If the defendant is liable for the winning plaintiff's litigation costs, then the amount at stake in the dispute increases. Both the plaintiff's minimum demand and the defendant's maximum offer increase. Thus, litigation will occur if

$$(3)\ P_p(J + C_p) - C_p + S_p > P_d(J + C_p) + C_d - S_d.$$

This inequality can be simplified and stated in a form similar to inequality (2), such that litigation occurs if

$$(4)\ (P_p - P_d)(J + C_p) > (C_p + C_d) - (S_p + S_d).$$

The effect on the rate of litigation of charging the losing defendant the plaintiff's litigation costs is obvious. The left-hand term of inequality (4), $(P_p - P_d)(J + C_p)$ (the favored plaintiffs rule), is greater than the left-hand term of inequality (2), $(P_p - P_d)J$ (the American rule), by the addition of C_p to the stakes of the case. Thus, for a given difference in the parties' estimates of success $(P_p - P_d)$, the likelihood of litigation is greater if the losing defendant must pay the winning plaintiff's attorneys' fees.

C. The Distributive Effects of Awarding Attorney's Fees

How will the award of attorney's fees to a winning plaintiff alter the plaintiff's substantive position in settlement negotiations? The American rule, requiring each party to pay its own litigation costs, deters litigation if litigation costs are a relatively large proportion of the amount at stake in the dispute. A numerical example illustrates the problem. Imagine that the amount at stake in the dispute is \$1000 to both plaintiff and defendant, litigation costs to each are \$1000, and settlement costs to each, \$100. Imagine, also, that both plaintiff and defendant believe that the plaintiff has a very strong (say, 0.8) chance of success at trial. Under the American rule:

the plaintiff's minimum demand

$$= 0.8(\$1000) - \$1000 + \$100 = -\$100;$$

$$(5a)\qquad = P_pJ - C_p + S_p$$

the defendant's maximum offer

$$= 0.8(\$1000) + \$1000 - \$100 = \$1700.$$

$$(5b)\qquad = P_dJ + C_d - S_d$$

Clearly, under the American rule the net expected value to the plaintiff of commencing litigation is negative. Of course, the net expected loss to the defendant from litigation is even greater, and the parties might strike a bargain at some amount between −\$100 (more realistically, zero) and \$1700.

Our discussion of litigation and settlement to this point has ignored

the possibility of strategic action on the part of either litigant, however. In a dispute such as that described in equations (5a) and (5b), if the plaintiff in settlement negotiations considers only his own expected gain from litigation (rather than the defendant's loss),[18] or if the defendant could induce the plaintiff to believe that he would refuse to settle on any terms (perhaps by reputation from past lawsuits), the defendant may avoid making any payment to the plaintiff. Litigation cannot enrich the plaintiff, although it can inflict a large loss on the defendant. Of course, the plaintiff can threaten litigation, and if the defendant is uncertain about the plaintiff's assessment of the prospects of victory or of the magnitude of litigation costs, then the threat may be credible. But if the defendant is determined, the plaintiff may be unable to threaten suit with sufficient persuasiveness to elicit any settlement offer from the defendant.

In theory, the results of these mutual threats are indeterminate, although they are likely to be influenced by what is impressionistically referred to as the relative bargaining strengths or positions of the parties. Of course, the members of Congress awarded litigation costs to winning plaintiffs in contexts (consumer, environmental, and civil rights litigation) in which the bargaining position of the defendant (manufacturer, polluter, white discriminator) is commonly regarded as substantially greater than that of the plaintiff.[19]

How does the award of litigation costs change the parties' relative bargaining positions? Using the same figures as in equations (5a) and (5b), if the defendant must reimburse the winning plaintiff for his litigation expenses, then both the minimum demand and the maximum offer shift upward:

the plaintiff's minimum demand

$$= 0.8(\$1000 + \$1000) - \$1000 + \$100 = \$700;$$

(6a) $$= P_p(J + C_p) - C_p + S_p$$

the defendant's maximum offer

$$= 0.8(\$1000 + \$1000) + \$1000 - \$100 = \$2500.$$

(6b) $$= P_d(J + C_p) + C_d - S_d$$

Here, the plaintiff's bargaining position is substantially different. Both the demand and offer are greater than under the American rule (equations (5a) and (5b)) by \$800—the plaintiff's litigation costs discounted by the probability of his success.[20] Thus, the range for negotiation has shifted from −\$100 to \$1700, under the American rule, to from \$700 to \$2500, under a system that awards litigation costs to the plaintiff. More important, the plaintiff now stands to gain from litigation even if the defendant makes no settlement offer. The defendant again stands to lose from litigation far more than the plaintiff will gain. But the plaintiff's ability to convince the defendant that he will pursue the legal action is now substantially greater than it was before.

II. COERCION TOWARD SETTLEMENT: EFFECTS ON LITIGATION

F.R.C.P. 68 is a variant of what are called "offer-of-judgment"[21] rules. In general, such rules provide that if a defendant, prior to trial, formally presents the plaintiff with an offer to settle the dispute, if the plaintiff rejects the offer, and if the judgment rendered is less than the amount of the offer, then the plaintiff must pay the costs that the defendant incurred after the offer was presented. thus, under most such rules, the formal presentation constrains the plaintiff either to accept the offer and settle the dispute or to litigate the dispute subject to the now-added risk of having to pay all of the defendant's subsequent litigation costs if the plaintiff loses the case[22] or if the plaintiff recovers a judgment no greater than the offer.

How will requiring the losing plaintiff to pay the defendant's litigation costs affect the litigation-settlement rate? A common view is that the imposition of this greater risk on the plaintiff will encourage a relatively greater frequency of settlements. For example, according to the Supreme Court in *August,*

> In all litigation, the adverse consequences of potential defeat provide both parties with an incentive to settle in advance of trial. Rule 68 provides an additional inducement to settle in those cases in which there is a strong probability that plaintiff will obtain a judgment but the amount of recovery is uncertain.[23]

The theory of the offer-of-judgment rule is that if the plaintiff's expected gain from litigation is reduced, because the plaintiff risks paying both his own and the defendant's litigation costs if he loses, then the plaintiff will find the defendant's settlement offer more attractive and will be more likely to accept it.

To understand the effect of the offer-of-judgment rule on the decision to litigate or settle, we first consider the general effect of assessing the losing plaintiff with the litigation costs of the prevailing defendant, what might be called a favored-defendants rule. The offer-of-judgment rule is only a special case of a favored-defendants rule, since the plaintiff must pay the defendant's litigation costs not only if he loses the case, but also if he wins the case but by an amount less than the offer.

Charging litigation costs to the losing plaintiff is simply the converse of the civil rights and consumer rules awarding costs to prevailing plaintiffs. Again, accepting the American rule (each party bears its own costs) as the starting point, the favored-defendants rule reduces both the plaintiff's minimum demand and the defendant's maximum offer by the amount of the defendant's litigation costs, C_d,[24] multiplied by the parties' estimates that the defendant rather than the plaintiff will win, $(1 - P_p)$ and $(1 - P_d)$, respectively. Again, litigation occurs if the plaintiff's minimum demand exceeds the defendant's maximum offer, which under this rule can be described as

$$(7)\ P_p J - C_p - (1 - P_p)C_d + S_p > P_d J + C_d - (1 - P_d)C_d - S_d.$$

Simplified, litigation will occur if

$$(8)\ (P_p - P_d)(J + C_d) > (C_p + C_d) - (S_p + S_d).$$

Inequality (8) closely resembles inequality (4),[25] which shows the litigation condition if favored plaintiffs recover attorneys' fees from defendants. In inequality (4), the favored-plaintiffs rule, litigation occurs if the difference between the parties' estimates of success times $J + C_p$ is greater than the difference between litigation and settlement costs. In inequality (8), the favored-defendants rule, litigation occurs if the difference between the parties' estimates of success times $J + C_d$ is greater than the difference between litigation and settlement costs. The only difference between the two contrasting rules is the substitution of C_d for C_p in the term representing the amount at stake in the dispute.

The similarity of the two inequalities shows that the effect of the favored-plaintiffs and favored-defendants rules on the rate of litigation is similar. Relative to the American rule, both rules increase rather than diminish the likelihood of litigation.[26] Under the American rule, the amount at stake between the parties is simply J, the expected judgment. But under the favored-plaintiffs and favored-defendants rules, the amount at stake between the parties is $J + C_p$ and $J + C_d$, respectively. If the amount at stake between the parties is greater, the likelihood of litigation is greater. A given difference between the parties' estimates of success is more likely to lead settlement negotiations to break down, because the difference will be greater between the plaintiff's minimum demand and the defendant's maximum offer.

The difference between the offer-of-judgment rule and the favored-defendants rule, as mentioned, is that the plaintiff must pay the defendant's litigation costs under the offer-of-judgment rule not only if he loses the case,[27] but also if he wins the case but by an amount less than the offer. Including this additional wrinkle in the model makes the effect of the offer-of-judgment rule on the rate of litigation analytically ambiguous. However, under the most plausible empirical assumptions, the effect of the rule will be similar to the favored-plaintiffs and favored-defendants rules: relative to the American rule, the offer-of-judgment rule will increase the rate of litigation.

To simplify exposition, assume that the judgment J can only be one of two figures, J_x, an amount greater than the offer, or J_y, an amount less than the offer. Define P_{px} and P_{dx} as the parties' respective estimates that the judgment will equal J_x, and P_{py} and P_{dy} that the judgment will equal J_y. By assumption, $P_{px} + P_{py} = P_p$ and $P_{dx} + P_{dy} = P_d$. Litigation will ensue if

$$(9)\ P_{px} J_x + P_{py}(J_y - C_d) - C_p - (1 - P_p)C_d + S_p > P_{dx} J_x + P_{dy}(J_y - C_d) + C_d - (1 - P_d)C_d - S_d.$$

Simplified, litigation occurs if

$$(10)\ (P_{px} - P_{dx})J_x + (P_{py} - P_{dy})J_y + (P_{px} - P_{dx})C_d > (C_p + C_d) - (S_p + S_d).$$

With one further simplifying assumption, the effect of the offer-of-judgment rule on the rate of litigation, as compared with the American rule, becomes clear. If, under the American rule, a case were to arise in which the judgment J (as in inequalities (9) and (10)) could only be either of two amounts, J_x and J_y, litigation would occur if

$$(11)\ (P_{px} - P_{dx})J_x + (P_{py} - P_{dy})J_y > (C_p + C_d) - (S_p + S_d).$$[28]

The left-hand term of inequality (10), the offer-of-judgment rule, is greater than the left-hand term of inequality (11), the American rule, by the term $(P_{px} - P_{dx})C_d$. Since C_d, the defendant's litigation costs, is always positive, the offer-of-judgment rule will lead to greater litigation than the American rule if P_{px} exceeds P_{dx}, that is, if the plaintiff's assessment of the probability of a judgment greater than the offer exceeds the defendant's assessment of the same probability.[29]

Again, it is a general precondition for litigation that the plaintiff be more optimistic than the defendant with respect to the outcome, that is, that P_p exceed P_d. It is an empirical rather than an analytical question whether, given P_p greater than P_d, more disputes will exist in which P_{px} will exceed P_{dx} than the reverse. It is most likely, however, that plaintiffs who are relatively optimistic on the whole will also be relatively optimistic with respect to the likelihood that the verdict will exceed the offer.[30] If so, then the offer-of-judgment rule will increase litigation relative to the American rule because, for a given difference in the parties' expectations, the stakes are higher under the offer-of-judgment rule.

What accounts for the confusion of the Supreme Court and of our common intuitions about the effect of the favored-defendants and offer-of-judgment rules on the litigation rate? The basic theory of these rules is that because they increase the downside risk of litigation to the plaintiff, he will be more likely to accept the defendant's settlement offer than he would under the American rule.[31] Because the downside risk is greater, the settlement offer will appear more attractive.

At its most basic level, this view ignores the reciprocal influence of changes in expected costs and benefits on the process of negotiating the settlement of a dispute. Admittedly, the offer-of-judgment and favored-defendants rules will reduce the expected value of litigation to the plaintiff relative to the American rule. As a consequence, for a similar dispute and for similar litigation and settlement costs, a plaintiff will be more willing to accept a lower settlement offer under these rules than under the American rule.

The offer-of-judgment and favored-defendants rules influence the value of litigation to both the plaintiff and defendant, however. While the expected return from litigation is lower to the plaintiff, the expected cost of litigation is lower to the defendant as well. Thus, the offer that the defendant submits under an offer-of-judgment or a favored-defendants rule will be lower than the offer he submits under an American rule given

similar conditions. If the plaintiff's minimum demand and the defendant's maximum offer are reduced by the same amount, then the offer will appear equally unattractive to the plaintiff under either rule.

A more subtle intuition might acknowledge the reciprocal effect of changes in costs but emphasize the effect of any change that depresses the expected value of litigation. Since the offer-of-judgment and favored-defendants rules diminish the expected value of litigation to both the plaintiff and defendant, they might reduce the likelihood of litigation, because the amount at stake in the dispute will be lower.[32] If the amount at stake is lower, for a given difference in estimates of success, then the plaintiff's demand is less likely to exceed the defendant's offer.

But this intuition is also mistaken. As inequalities (7) and (9) show, the favored-defendants and offer-of-judgment rules diminish the parties' settlement offers by the amount of the defendant's litigation costs, C_d, times the parties' estimates that the defendant will win, $(1 - P_p)$ and $(1 - P_d)$, respectively. These products correspond to the downside risk to the plaintiff and the upside risk to the defendant of a defendant verdict. However, if litigation costs exceed settlement costs, litigation will occur only if the plaintiff's estimate of success, P_p, exceeds the defendant's, P_d; that is, $(P_p - P_d)$ must be positive (see inequalities (2), (4), (8), and (10)). If the plaintiff's estimate of a plaintiff verdict exceeds the defendant's estimate, then the defendant's estimate of a defendant verdict must exceed the plaintiff's; thus, for litigation to occur, $(1 - P_d)$ must exceed $(1 - P_p)$. It follows, for the range of disputes in which litigation may occur, that the amount deducted from the defendant's offer because of these rules will be greater than the amount deducted from the plaintiff's demand. Thus, for these cases, the favored-defendants and offer-of-judgment rules, while diminishing offers and demands generally, will diminish the defendant's offer by a greater amount than they will diminish the plaintiff's demand. The gap between the plaintiff's demand and the defendant's offer will grow larger, and the likelihood of litigation will increase.

What are the distributive effects to plaintiffs and defendants of the favored-defendants and offer-of-judgment rules? We first examine the effect of the favored-defendants rule, according to which the plaintiff is liable for the defendant's costs only if a defendant verdict is rendered. As before, let the amount at stake be \$1000, litigation costs to each party, \$1000, and settlement costs to each, \$100. Again, both plaintiff and defendant agree that the plaintiff has a 0.8 chance of success at trial. By equation (7), according to these assumptions:

the plaintiff's demand

$$= 0.8(\$1000) - \$1000 - (0.2)\$1000 + \$100 = -\$300;$$

(12a) $$= P_p(J) - C_p - (1 - P_p)C_d + S_p$$

the defendant's offer

$$= 0.8(\$1000) + \$1000 - (0.2)\$1000 - \$100 = \$1500.$$

(12b) $$= P_p(J) + C_d - (1 - P_d)C_d - S_d$$

With similar values for these variables under the American rule (equations (5a) and (5b)), the plaintiff's minimum demand is −$100 and the defendant's maximum offer, $1700. As is evident under the favored-defendants rule, the plaintiff is worse off and the defendant better off by $200, the defendant's litigation costs times the probability of a defendant verdict. Moreover, under the rule, the plaintiff's strategic position is eroded even further than under the American rule. If the plaintiff stands to lose $300 rather than $100 from litigating the case (taking into account his very high probability of success), then it is less likely that the plaintiff will be able convincingly to threaten litigation to elicit a settlement offer of any amount from the defendant.

The plaintiff can be even worse off under the offer-of-judgment rule, according to which the plaintiff is liable for the defendant's litigation costs if the judgment rendered is no greater than the defendant's offer. To illustrate, imagine that the defendant has submitted a formal settlement offer of $100. Let the plaintiff and defendant agree that there is a 0.65 chance of a plaintiff verdict of $1200, a 0.20 chance of a plaintiff verdict of $100, and a 0.15 chance of a defendant verdict (the expected value of these potential verdicts equals $800, which is equal to the expected judgment in our previous examples). Again, litigation costs are $1000 and settlement costs, $100 to each party. According to these assumptions:

the plaintiff's demand

$$= 0.65(1200) + 0.20(\$100 - \$1000)$$
$$= -\$1000 - 0.15(\$1000) + \$100 = -\$450;$$

the defendant's offer

$$= 0.65(1200) + 0.20(\$100 - \$1000) + \$1000 - 0.15(\$1000) - \$100 = \$1350.$$

Now the plaintiff has a net expected loss from continuing litigation of $450; his position has deteriorated further.[33]

The offer-of-judgment rule will impose similar effects in the context of suits brought under the favored-plaintiffs rule. Using the same numerical assumptions, equations (6a) and (6b) show that under the favored-plaintiffs rule alone, the plaintiff could expect to gain $700 from litigation, and the defendant, to lose $2500. But if the offer-of-judgment rule were also to apply, the plaintiff's expected gain from litigation would fall to $200 and the defendant's expected loss would fall to $2000.[34] Although the plaintiff in this example can expect to recover something from litigation, the expected value of litigation is positive by only a small amount. Indeed, we have assumed in these examples that the favored plaintiff has a very high chance of success, 0.80. If the plaintiff's chances were diminished slightly, there would be no positive gain from litigation. Using the same values, if the plaintiff's chance were to diminish to a 0.58 (instead of a 0.65) chance of a $1200 judgment, the expected value of litigation would be negative. Here, a 0.58 chance of a $1200 judgment, plus the 0.20 chance of a $100 judgment, corresponds to a 0.72, rather

than a 0.80, chance of a $1000 judgment. Thus, given a very small change in the probability of success, the offer-of-judgment rule completely extinguishes the potential gain from litigation to a favored plaintiff. The plaintiff's ability to threaten litigation to elicit a settlement offer from the defendant is similarly diminished.

III. *DELTA AIR LINES, INC. V. AUGUST:* THE ISSUES RECONSIDERED

Sections I and II demonstrate that relative to the American rule, the favored-plaintiffs rule encourages litigation while enhancing the position of plaintiffs, and that the offer-of-judgment rule is likely to encourage litigation while enhancing the position of defendants. How did the Supreme Court choose between these effects in *August?* The question is of special interest, because the Court often has expressed a desire both to encourage the vindication of civil rights and to diminish the general rate of litigation.

Delta fired Rosemary August, a black stewardess, in 1975. She filed suit under Title VII of the Civil Rights Act of 1964,[35] claiming that Delta had discriminated in working conditions between blacks and whites and that she had been fired because of her race. Subsequently, Delta, pursuant to F.R.C.P. 68, offered to settle the case for $450. August rejected the settlement offer, the case was tried, and the district court held that August had not presented evidence sufficient to show discrimination, entering judgment for Delta. Delta then moved to recover its costs and attorneys' fees, alleged to exceed $10,000,[36] from August. But the district court denied the motion to recover fees, and the court of appeals affirmed the denial.[37] Delta asked the Supreme Court to overturn the denial.

The Supreme Court framed the legal issue as resting upon that clause of Rule 68[38] providing that the plaintiff must pay costs if "the judgment finally obtained by the [plaintiff] offeree is not more favorable than the offer." According to the Court, the legal question was whether this clause refers only to judgments in favor of the plaintiff in amounts less than the offer, or also to judgments against the plaintiff (offeree), such as the judgment in favor of Delta. To appreciate the significance of this distinction, we must observe more carefully the interaction of the various rules governing the assignment of costs and fees.

First, as mentioned earlier, the Civil Rights Attorneys' Fees Awards Act[39] empowers a court, at its discretion, to award costs and attorneys' fees to a plaintiff suing under the Act if the plaintiff prevails. Technically, the Act allows a court to make a similar award to a prevailing defendant, although prevailing defendants recover both costs and attorneys' fees only infrequently.[40] Second, Federal Rule 54(d) empowers courts to award "costs" to prevailing parties, whether plaintiffs or defendants. Costs are defined separately in the U.S. Code as clerks' and marshals' fees, court reporter charges, printing and witness fees, copying costs, interpreting costs, and the fees of court-appointed experts.[41] Obviously,

attorneys' fees, much the larger part of total litigation expenses, are not included specifically in this definition. Again, under Rule 54(d), the award of costs is discretionary to a court. However, some courts have exercised this discretion to award both attorneys' fees and costs.[42]

Finally, Rule 68 provides that a defendant may recover the costs that it incurred after making a settlement offer if the plaintiff does not recover a judgment greater than the amount of the offer. The rule is not reciprocal; it does not authorize plaintiffs' recovery of costs under any conditions. The rule does not define the term "costs." The most important difference between Rule 68 and the other cost rules, however, is that the award of costs under Rule 68 is mandatory. Unlike the Civil Rights Act or Rule 54(d), Rule 68 does not grant discretion to a court to deny the award of costs.

The Supreme Court's consideration of the issues in *August* was influenced substantially by two differences among these various rules: first, their mandatory or discretionary character; and second, the differential manner in which courts had exercised the discretion to award costs. The award of costs and fees under the Civil Rights Act is discretionary, although prevailing plaintiffs apparently recover very often and prevailing defendants, only occasionally.[43] Similarly, the award of costs to prevailing parties under Rule 54(d) is discretionary. Again, it was alleged that prevailing plaintiffs were much more likely to be granted costs than prevailing defendants.[44] But the award of costs under Rule 68 is mandatory. Indeed, Delta's argument in the case consisted primarily of an insistence that Rule 68 be read literally, emphasizing its mandatory character.[45]

The principal source of disagreement in the case derived from the conflict arising from the mandatory character of Rule 68 and the discretionary character of Rule 54(d). Together, these two rules could create peculiar incentives for the parties, incentives that were the focus of the Court's attention. Considering the manner in which the two rules had been applied, a defendant was substantially better off by submitting a settlement offer under Rule 68 than by submitting no offer at all. If the defendant had submitted an offer, any offer, and the defendant won the case, then it could recover costs (and perhaps fees) under Rule 68's mandatory provision. But if no offer were submitted, the defendant could only apply to the court for costs, with a low chance of success, in light of past experience. Thus, the rules created an incentive for a defendant to submit a Rule-68 settlement offer to the plaintiff, whether or not it was realistic for the plaintiff to accept it.

Both the court of appeals and the Supreme Court concentrated on this peculiarity. The court of appeals emphasized that if Rule 68 were interpreted literally, a settlement offer of $10 would suffice to shift liability for the defendant's costs to the plaintiff.[46] The Supreme Court, with finer analytic sense, stressed that interpreted literally, a settlement offer under Rule 68 of "one penny" would trigger a shift of costs.[47] Indeed,

this discontinuity in the incentives created by the rules confused and divided the Court. Justice Stevens, speaking for the majority, asked how one could justify providing the defendant with a better chance of recovering its costs solely because it had submitted a token settlement offer.[48] Justice Rehnquist, joined by Chief Justice Burger and Justice Stewart, in dissent, argued that unless Rule 68 were interpreted literally, the defendant would be worse off if it won the case than if it lost the case.[49] If the defendant won the case, it would face the indifferent chance of cost recovery under Rule 54(d). If it lost the case, but the judgment was less than the offer, then the defendant would recover its costs automatically under Rule 68. Rehnquist's concern was echoed by Justice Powell[50] concurring with the majority result.

The principal source of the problem is the conflict between the mandatory and discretionary character of Rules 68 and 54(d). The manifestation of the problem is the defendant's submission of a token offer, one not designed to elicit the plaintiff's acceptance. Why would the defendant submit an offer that the plaintiff is certain to refuse? Again, prior to *August,* Rule 68 allowed a defendant to recover costs if the judgment in favor of the plaintiff was less than the defendant's offer or if the defendant recovered judgment. By definition, the amount of a token offer is less than the expected value of the judgment (the judgment discounted by the likelihood of a plaintiff verdict). Hence, the defendant generally will not be expecting the eventual judgment to be less than the offer.[51] Instead, the defendant submits a token offer to recover costs under the Rule-68 situation in which the defendant recovers a verdict. If the victorious defendant has submitted a token offer, then he can invoke the mandatory cost recovery of Rule 68. If, on the other hand, the defendant has not submitted an offer, he can only apply to the discretion of the court to recover costs under Rule 54(d).

Because of the difference between the mandatory and discretionary character of these rules, it is always advantageous for a defendant to submit a token offer if the dispute cannot be settled on mutually agreeable terms. The submission of a token offer costs the defendant nothing and gains the defendant the greater likelihood of recovering costs under the mandatory Rule 68 than under the discretionary Rule 54(d). Indeed, in the first instance, the defendant's strategically optimal token offer is an amount just below the plaintiff's estimate of the expected value of the case. Such an offer allows the defendant to recover costs upon a defendant judgment and, further, maximizes the chance of recovering costs upon a plaintiff judgment less than the offer. Thus, the closer the offer is to the plaintiff's expected value of the case, the greater is the defendant's advantage.

The essence of the strategy, though, is to submit an offer that the plaintiff will *not* accept. The defendant may lose substantially if the offer is not unrealistically low. If the plaintiff accepts the offer, the defendant both pays the offer amount to the plaintiff and loses the opportunity to

recover costs under Rule 68. Thus, because as a strategic countermove the plaintiff may accept the offer, the Rule 68-Rule 54(d) discontinuity is likely to guarantee offers that are truly tokens. A defendant is likely to allow a substantial margin between the amount of the offer and the expected value of the case to insure that the plaintiff will not accept it.[52]

The district court, perceiving the incentive to submit a token offer, denied Delta's motion for costs on the ground that Delta had submitted the offer in "bad faith."[53] The court of appeals, in slightly different terms, affirmed the denial of Delta's motion, because its offer, in the view of the court, was not sufficient to justify "serious consideration" by August.[54] These two approaches would make Rule 68 discretionary rather than mandatory. The incentive to submit a token offer would not be eliminated, although individual judges could easily diminish it.

The most obvious weakness of either approach is the knowledge that it requires of a judge trying to apply it. How is a court to define "bad faith" or to identify those offers unworthy of "serious consideration?" Resolving the matter is easy with extreme examples, the $10 or one penny offers. However, the bad faith or seriousness of an offer must be defined with respect to the expected value of the judgment to the parties at the time the offer is made. The expected value of the judgment is determined importantly by the plaintiff's expected likelihood of success; indeed, it is defined as the judgment discounted by the likelihood of success.

Is it appropriate to engage the judiciary in this form of evaluation of a dispute? In some cases, those tried before juries, for example, a judge might be competent to evaluate accurately the probability of success. But if the case is tried before a judge himself, can the judge, or is it appropriate for the judge, to estimate the plaintiff's likelihood of success? The estimation must be framed in terms of the likelihood of success at the time the offer is submitted, that is, *prior* to trial. Thus, the judge must evaluate the plaintiff's chances considering the parties' pretrial views of the evidence and of how it would develop at trial as well as the parties' pretrial estimates of the success and importance of substantive or evidentiary motions of one kind or another. Moreover, in cases tried before judges, the parties may take into account the individual attitudes of the judge in calculating a "serious" settlement offer. Should the judge that ruled on the case, or even a colleague, evaluate the *ex ante* influence of these attitudes on the outcome? On the other hand, should a court declare or pretend that judicial attitudes are irrelevant and, thus, disregard influences that the parties take seriously? Judges commonly rule on the likelihood of success in extreme cases: upon allegations of frivolousness or of the complete absence of evidence. However, a "token" (that is, an unacceptable) offer need not be extreme. As explained earlier, it may be most advantageous to a defendant to submit an offer just less than the plaintiff's estimate of the value of the case.

The Supreme Court did not entertain the standard proposed either by the district court or by the court of appeals.[55] There appear to be four other possible avenues, presumably considered by the Court, for resolving the discontinuity created by the mandatory-discretionary difference between Rules 68 and 54(d). Several of the avenues, including that taken by the Court, eliminate the Rule 68-rule 54(d) discontinuity, although each has different effects on the rate of litigation and the distributive position of plaintiffs and defendants. But as we shall see, none of the avenues completely eliminates the incentive to submit a token offer.

First, the Court might have interpreted (more cleanly, amended) Rule 68 to make its application discretionary to a court on grounds not requiring a precise evaluation of the likelihood of the plaintiff's success. For example, the Court might have incorporated the standard it had announced recently in *Christiansburg Garment Co. v. EEOC,*[56] according to which defendants may recover costs under the Civil Rights Act if the plaintiff's action is meritless, unfounded, or vexatiously brought. If cost recovery under Rule 68 were discretionary instead of mandatory, and if the courts applied similar standards to the exercise of Rule 68 and Rule 54(d) discretion, then there would be no advantage gained from an offer that triggered Rule 68. Making Rule 68 discretionary, however, would weaken its effect on the volume of litigation. The Supreme Court believed, as we have seen, mistakenly, that an offer-of-judgment rule reduces the volume of litigation. Indeed, the Court in *August* emphasized the importance of the effect.[57] Perhaps for this reason the Court refused to disturb Rule 68's mandatory character.

Second, the Court might have interpreted (or again more cleanly, amended) Rule 54(d) to make its application mandatory rather than discretionary. If it were clear that a defendant could recover costs under Rule 54(d) whenever it won the case, then no advantage could be gained by the submitting of an offer to invoke Rule 68. However, if a Rule-54(d) award were mandatory, then the particular advantage now enjoyed by favored plaintiffs would disappear. All prevailing parties would recover costs and fees. More important, in many instances prevailing defendants would be awarded costs against favored plaintiffs. The congressional and judicial[58] objective of benefitting such plaintiffs would be thwarted.

Third, the American Civil Liberties Union as amicus urged the Court to limit the definition of "costs" under Rule 68 to the set of various court fees,[59] specifically not including attorneys' fees.[60] Thus, August would be liable to Delta under Rule 68, but for a significantly smaller sum than under a broader interpretation of the term "costs." The ACLU apparently believed that this definition would reduce the extent to which Rule 68 discouraged litigation seeking to vindicate civil rights.[61]

Such an interpretation would not have removed the incentive to submit a token offer, although it would have reduced the advantage to defendants from the tactic. The Court might also have believed that such an interpretation would sap the force of Rule 68 in reducing the rate of

litigation. If so, the Court again was mistaken. Any interpretation of the costs to be allocated by these rules that lowers the magnitude of amounts to be shifted—in the inequalities, lowering the magnitude of C_p or C_d —will diminish the rate of litigation, not increase it.

Finally, the Court chose to interpret Rule 68 to apply only if the plaintiff recovered judgment in an amount less than the offer, and never if the defendant recovered a judgment. This interpretation, as the Court explicitly recognized,[62] eliminates the strategic advantage of invoking the mandatory Rule 68 over the discretionary Rule 54(d). This interpretation removes all areas of overlap between the rules. If a defendant recovers a judgment, only Rule 54(d) applies; if the plaintiff recovers a judgment less than the offer, only Rule 68 applies.

Concomitantly, the Court's interpretation of Rule 68 reduces the range of disputes for which the rule might influence the litigation-settlement decision. The Court seemed to regret reducing the rule's effectiveness, because of its mistaken view that the rule diminished the litigation rate.[63] The more important concern to the Court, however, seemed to be the protection of the interests of favored plaintiffs. Faced with a choice, the Court sacrificed part of Rule 68 so as not to deter the litigation of favored plaintiffs.

The Court's concern reflects its confusion over the Rule's effect on the rate of litigation, but also its accurate sense of the distributive effects of the various cost rules. The Court's judgment improves the position of favored plaintiffs and, for that matter, of all plaintiffs subject to Rule 68. No longer must such plaintiffs, upon the submission of a Rule-68 offer, deduct from their settlement demands the defendant's costs discounted by the likelihood of a defendant verdict.

Neither the Court's interpretation of Rule 68 nor the other approaches available in *August* will completely eliminate the incentive to submit a token settlement offer, however. The advantages of the token offer are endemic to any form of an offer-of-judgment rule. Once serious settlement negotiations have failed, one would expect all defendants to submit token settlement offers, apart from the risk of antagonizing the court. A simple numerical example shows why this is so. Imagine a dispute in which it is clear that the plaintiff will recover a verdict, but damages are uncertain. The defendant estimates that there is a ten percent chance of a $100 verdict, an eighty percent chance of a $1000 verdict, and a ten percent chance of a $1900 verdict. The expected judgment to the defendant $((0.1 \times \$100) + (0.8 \times \$1000) + (0.1 \times \$1900))$ is equal to $1000. However, assume that the plaintiff is more optimistic than the defendant and that the parties are unable to settle the dispute. Even under the Supreme Court's interpretation of Rule 68 in *August,* the defendant can gain from submitting an offer substantially lower than the expected value of the dispute. If settlement negotiations fail and the defendant submits a Rule-68 offer of $101, the defendant gains a ten percent chance of recovering its litigation costs. This advantage may be substantial; in *Au-*

gust, it was alleged that Delta's post-offer litigation expenses equaled $10,000.[64]

Under an offer-of-judgment rule, a defendant gains from submitting a token offer regardless of the magnitude of its litigation expenses. The submission of a token offer imposes no costs on a defendant. Because the offer is unrealistically low, it will not be accepted. Yet, the submission alone gains a defendant some chance of recovering litigation expenses. The advantages of a token offer do not derive from some peculiarity of the numerical example. The incentive to submit a token Rule-68 settlement offer could only be eliminated by elimination of the rule itself. Considering the Court's restrictive interpretation of Rule 68, a defendant now is most likely to gain from a token offer in disputes in which the amount of damages is at issue. Indeed, suits brought under favored-plaintiffs statutes may be especially susceptible to token offers. In such suits, involving claims of discrimination or pollution, for example, it is difficult to prove actual damages. Nominal awards are often granted.

The Court, as mentioned,[65] interpreted the advantage gained by a defendant from a Rule-68 settlement offer as a needed stimulus to settlement. But, the Rule's principal effect, even as interpreted, is distributive: plaintiffs become worse off. Indeed, Rule 68 is most likely to encourage settlement by those plaintiffs least able to withstand the adverse effect of paying the defendant's litigation expenses. Although identifying the rule's differential incentive effects is an empirical question, in my view the rule is likely to bludgeon into settlement those plaintiffs most sensitive to small distributional shifts. These are the same plaintiffs most responsive to the favored-plaintiffs statutes. With respect to all other plaintiffs, the rule will only discourage settlement and encourage litigation.

IV. CONCLUSION

The Supreme Court's opinion in *Delta Air Lines, Inc. v. August* demonstrates its intuitive but imprecise understanding of the effects of the various cost-shifting rules. The Court's principal concern was the distributional effects of the rules. Compared with a broader interpretation of Rule 68, the Court's interpretation will aid plaintiffs relative to defendants and is likely to aid especially plaintiffs filing suits under favored-plaintiffs statutes. Nevertheless, compared with the American rule alone, favored plaintiffs and plaintiffs generally are worse off under an offer-of-judgment rule such as Rule 68. Of course, *August* itself was not the appropriate occasion to jettison the rule altogether.

The Court's appreciation of the effect of its decision on the rate of litigation was less accurate, however. The Court feared that its restrictive interpretation of Rule 68 would impair the Rule's influence toward reducing litigation. But an offer-of-judgment rule is likely to increase, not reduce, the litigation rate. Thus, compared with the broader interpreta-

tion of Rule 68 that it thought it was sacrificing, the Court's interpretation is likely to reduce the litigation rate after all. *August* represents for the Court a happy but unwitting coincidence of objectives. The rate of litigation is likely to be reduced even further by elimination of the offer-of-judgment rule altogether and by a return to the American rule.

Finally, following *August,* it is difficult to view the current status of the law of cost-shifting as totally coherent. Under some conditions the Court has prescribed rules making cost-shifting mandatory; under other conditions, discretionary. Rules of law that enhance the position of certain plaintiffs to encourage litigation by them will always conflict with rules of law, such as Rule 68, that impair the position of plaintiffs generally. Economic analysis can be helpful in unraveling the likely effect of these various rules and in making more precise the intuitive objectives toward which the Court was groping.

NOTES

1. 42 U.S.C. § 2000e *et seq.* The recovery of fees is empowered by the Civil Rights Attorneys' Fees Awards Act, 42 U.S.C.A. § 1988 (West Supp. 1978).

2. Fair Housing act of 1968, 42 U.S.C. § 3612(c) (1970).

3. Magnuson-Moss Warranty—Federal Trace Commission Improvement Act, 15 U.S.C. § 110(d)(2) (1976). Among other statutes providing for the recovery of attorneys' fees are the Freedom of Information Act, 5 U.S.C. § 552(a)(4)(E) (1976); Clayton Act, 15 U.S.C. § 15 (1976); Truth in Lending Act, 15 U.S.C. § 1640(a)(3) (1976); Consumer Product Safety Act, 15 U.S.C. § 2059(e)(4) (1976). Other statutes awarding fees are collected at Note, *Rule 68: A "New" Tool for Litigation,* 1978 DUKE L.J. 889, 898 & n.51, and in sources cited therein.

4. For a comprehensive survey *see* P. EBENER, COURT EFFORTS TO REDUCE PRETRIAL DELAY: A NATIONAL INVENTORY, R-2732-ICJ (Rand Corp. 1981).

5. *See* sources cited in Note, *supra* note 3, at 890 & nn.6 & 7.

6. *See infra* note 11.

7. At this point, to simplify analysis, I do not distinguish "costs," defined at 28 U.S.C. §§ 1920, 1927 as clerks' and marshals' fees, court reporter charges, printing and witness fees, copying costs, interpreting costs, and the fees of court appointed experts, from attorneys' fees, which obviously are much greater. Whether "costs" in Rule 68 incorporated attorneys' fees was a matter at issue in Delta Air Lines, Inc. v. August, 450 U.S. 346 (1981), which I discuss in the text accompanying *infra* notes 59-61.

8. *See* text accompanying *infra* notes 22-30. As a related example, Federal Rule of Civil Procedure 54(d) allows, but does not require, a judge to tax the losing party for "costs." It is widely believed that the prospect of liability for the defendant's costs will deter marginal litigation. Of course, the discretionary nature of the rule empowers a judge to deny the levy of costs against plaintiffs viewed as particularly deserving.

9. 450 U.S. 346.

10. Civil Rights Attorneys' Fees Awards Act, 42 U.S.C.A. § 1988 (West Supp. 1978).

11. Rule 68, as amended in 1966, provides:

> At any time more than 10 days before the trial begins, a party defending against a claim may serve upon the adverse party an offer to allow judgment to be taken against him for the money or property or to the effect specified in his offer, with costs then accrued. If within 10 days after the service of the offer the adverse party serves written notice that the offer is accepted, either party may then file the offer and notice of acceptance together with proof of service thereof and thereupon the clerk shall enter judgment. An offer not accepted shall be deemed withdrawn and evidence thereof is not admissi-

ble except in a proceeding to determine costs. If the judgment finally obtained by the offeree is not more favorable than the offer, the offeree must pay the costs incurred after the making of the offer. The fact that an offer is made but not accepted does not preclude a subsequent offer. When the liability of one party to another has been determined by verdict or order or judgment, but the amount or extent of the liability remains to be determined by further proceedings, the party adjudged liable may make an offer of judgment, which shall have the same effect as an offer made before trial if it is served within a reasonable time not less than 10 days prior to the commencement of hearings to determine the amount or extent of liability.

12. *See* text accompanying *infra* notes 35-63.

13. After this essay was substantially completed, Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs,* 11 J. LEGAL STUD. 55 (1982) appeared. This essay and Shavell's both analyze in similar terms the effects on the rate of litigation of the various cost and fee assignments; indeed, both derive from Posner, *An Economic Approach to Legal Procedure and Judicial Administration,* 2 J. LEGAL STUD. 399 (1973). The analysis in this essay differs from Shavell's in two principal respects. First, Shavell's model treats as independent the decisions to bring suit and to litigate once suit has been filed. This treatment is consistent with an assumption of no strategic actions by either litigant. The analysis in this essay introduces preliminary considerations of strategic actions that I believe to be crucial to understanding the legislative intent and effect of acts awarding costs to favored plaintiffs. *See* text accompanying *infra* notes 18-19. In other contexts, Shavell's assumption of the independence of suit and of litigation may be appropriate, although currently there are neither well-defined theories nor empirical studies of the litigation market. This difference between the models is also discussed at *infra* notes 18 & 26. Second, this essay differs from Shavell's in its separate consideration of the distributive effects on the parties of the various fee assignments irrespective of effects on litigation rates. *See* text accompanying *infra* notes 18-20, 32-34. Of course, this essay also addresses the effects of offer-of-judgment rules and the legal issues in *August,* which were beyond the scope of Shavell's essay. Shavell's economic model, on the whole, is more general than the one used in this essay, although subject to the strategic action qualification, our results are identical. Another recent article adopting a similar approach in the context of class actions is Dewees, Prichard, & Trebilcock, *An Economic Analysis of Cost and Fee Rules for Class Actions,* 10 J. LEGAL STUD. 155 (1981).

14. *But see supra* notes 5 & 8.

15. *See* Landes, *An Economic Analysis of the Courts,* 14 J.L. & ECON. 61 (1971). *See also* Priest, *Selective Characteristics of Litigation,* 9 J. LEGAL STUD. 399 (1980).

16. This formulation assumes that litigation costs are fixed and independent of the stakes, that the stakes of the case are identical to the parties, and that the parties are risk neutral. Risk aversion can be considered in the model simply by reducing the expected J to the party. *See also infra* note 26.

17. Again, at this point, I treat rules that shift costs or attorneys' fees as shifting all litigation costs of the affected parties. Obviously, rules that shift only some part of these composite charges will have effects of a similar nature, although diminished according to the proportion of total litigation charges not shifted. I consider the definition of "costs" and "fees" under the various procedural rules more carefully in the text accompanying *infra* notes 59-61.

18. Landes, *supra* note 15, Posner, *supra* note 13, and Shavell, *supra* note 13, all assume that the plaintiff will only bring suit if the net expected value of litigation is positive. Thus, in the example in equations (5a) and (5b), no suit would be filed and the defendant would pay nothing. I believe that this assumption is unrealistic and disregards congressional presumptions about the differential litigiousness of favored and non-favored plaintiffs.

19. *See* text accompanying *supra* notes 1-3 & note 3.

20. In equations (6a) and (6b), the demand and offer shift upward by the same amount, because the example assumes that the parties agree precisely on the probability of a plaintiff verdict. If the parties disagree and the plaintiff predicts a greater chance than the defendant of a plaintiff verdict (the minimum condition for litigation if litigation costs

exceed settlement costs), then the addition of the defendant's litigation costs to the stakes of the case will increase the plaintiff's demand by more than it will increase the defendant's offer. Thus, the likelihood of litigation will increase.

21. The defendant is offering to concede the entry of a judgment in favor of the plaintiff on the specified terms.

22. Whether the plaintiff must pay the defendant's costs if he loses the case rather than only if he recovers a judgment less than the amount of the offer was an issue in *August*. *See* text accompanying *infra* notes 35-63. Most jurisdictions with offer-of-judgment rules routinely award costs for defendant judgments. *See* Note, *supra* note 3.

23. 450 U.S. at 352.

24. The offer-of-judgment rule only applies to that portion of the defendant's costs incurred after the making of the offer while the favored plaintiffs rule applies to total costs. In terms of the litigation rate only, and disregarding distributive effects, this difference is unimportant. All costs that the defendant incurs prior to making the offer are sunk and thus do not affect expected future returns from settlement. I ignore here the strategic advantage of an offer under offer-of-judgment rules. *See* text accompanying *infra* notes 51-65.

25. *See* text following *supra* note 17.

26. Here, Shavell's emphasis on the independence of the decisions to file suit and to litigate given suit leads to results different from mine. Shavell argues that if a plaintiff is risk-averse, a rule such as the favored-defendants rule will diminish the likelihood of bringing suit. Thus, even if those suits brought are more likely to be litigated because of the rule, the net effect on litigation is ambiguous. Again, Shavell's formulation dismisses the possibility of strategic action. *See supra* note 13. There is no empirical evidence to show whether Shavell's treatment or mine is the more plausible.

27. *But see supra* note 22.

28. This formulation is an approximation only. Because the parties in this example form independent estimates of the likelihood of different verdicts, the difference between their expected values of the verdict, strictly speaking, may increase or decrease. Thus $P_{px} J_x + P_{py} J_y$ may not equal $P_p J$.

29. If $P_{px}=P_{dx}$, the litigation rate under the offer-of-judgment rule will equal that under the American rule; if $P_{px} < P_{dx}$, the litigation rate will be lower.

30. I discuss in the text accompanying *infra* notes 51-65 the strategic advantage to a defendant of submitting a token offer to the plaintiff. If a defendant submits a token offer, then the offer-of-judgment rule approaches the favored-defendants rule and, thus, is increasingly likely to increase the rate of litigation relative to the American rule. *See infra* note 52.

31. *See* text accompanying *supra* note 23.

32. This intuition conflicts with inequalities (8) and (10), which show that the offer-of-judgment rule as well as the favored-defendants rule will increase the amount at stake in the dispute by the amount of the defendant's costs.

33. Of course, given these numbers, it is unrealistic for the defendant to offer as much as $100. For further discussion of the strategic possibilities of nominal offers under an offer-of-judgment rule, *see* text accompanying *infra* notes 51-65.

34. Under both favored plaintiffs and offer-of-judgment rules, the conditions pertaining in *August*, litigation would occur if

$$(P_{px} - P_{dx})J_x + (P_{py} - P_{dy})J_y + (P_{px} - P_{dx})(C_p + C_d) > (C_p + C_d) - (S_p + S_d).$$

Adopting simplifying assumptions similar to those in inequality (11), the litigation rate would increase relative to the American rule by the value of $(P_{px} - P_{dx})(C_p + C_d)$, and relative to the offer-of-judgment rule alone by the value of $(P_{px} - P_{dx})(C_p)$.

35. 42 U.S.C. § 2000e *et seq.*

36. *See* Brief for Respondents at 6.

37. 600 F.2d 699 (7th Cir. 1979).

38. *See supra* note 11.

39. 42 U.S.C.A. § 1988 (West Supp. 1978).

40. According to a study by Delta, they do so 18 percent of the time. Reply Brief for Petitioner, Appendix.

41. 28 U.S.C. §§ 1920, 1927.

42. *See supra* note 40 and source cited therein.

43. The Supreme Court has defined standards under the Act justifying broad recovery of costs by civil rights plaintiffs and limited recovery of costs by civil rights defendants. *See* Christiansburg Garment Co v. EEOC, 434 U.S. 412 (1978).

44. *See supra* note 40 and source cited therein.

45. Brief for Petitioner.

46. 600 F.2d 699 (7th Cir. 1979).

47. 450 U.S. at 353 n.11.

48. *Id.*

49. *Id.* at 375 (Rehnquist, J., dissenting).

50. *Id.* at 362 (Powell, J., concurring).

51. *But see* text accompanying *infra* notes 64-65.

52. As the Rule-68 offer diminishes relative to the expected judgment, the offer-of-judgment rule approaches a favored-defendants rule. The effect of the rule, relative to the American rule, in increasing the rate of litigation, grows apace. In inequality (10), $(P_{px} - P_{dx})C_d$ approaches $(P_p - P_d)C_d$. If the Rule-68 offer is truly a token, say one penny, then the offer-of-judgment rule is equivalent to the favored-defendants rule, and the effect of the rule is unambiguously to increase the rate of litigation relative to the American rule.

53. *See* 450 U.S. at 349 n.3.

54. 450 U.S. at 349-350 & n.4, 600 F.2d at 701 (7th Cir. 1979) (footnote omitted).

55. 450 U.S. at 350.

56. 434 U.S. 412 (1978).

57. 450 U.S. at 352-353.

58. *See* Christiansburg Garment Co. v. EEOC, 434 U.S. 412, 418-419 (1978).

59. Set forth in *supra* note 7.

60. Brief for Amicus Curiae, American Civil Liberties Union, Delta Air Lines, Inc. v. August, 450 U.S. 346.

61. *Id.* at 4-5.

62. 450 U.S. at 353-355.

63. *Id.* at 352.

64. Brief For Respondent at 6.

65. 450 U.S. at 352.

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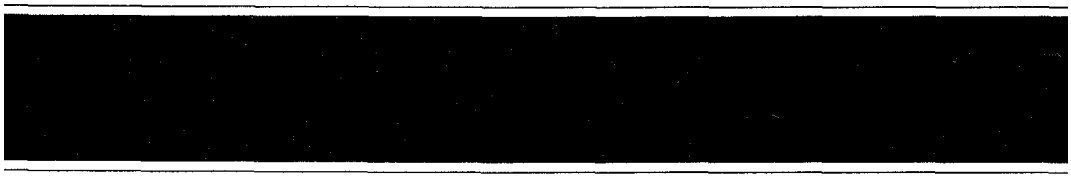
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