Law and Economics
Session 13
Legal Process 1

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- We've already covered the key ideas in the course, now we will build on those topics.
- Today: Legal Process 1
- Wednesday-Monday:
    - Property Law 2
    - Tort Law 2
    - Contract Law 2
    - Criminal Law 2

Economic Analysis of the Legal Process

- "The Legal Process" refers to how the judicial system operates.
- A trial court has to determine the facts of the case and decide how the law applies to those facts.
    - This process is expensive.
- Other issues:
    - When should the parties settle?
    - What trial fees should be imposed, if any?
    - What is the evidentiary threshold for liability/guilt?
    - What opportunities for appeal?

Substantive versus Procedural Law

- Our previous material looked mostly at the "substantive" aspects of law:
  - "Substantive" refers to the content of the legal rules and how they affect incentives, assuming that courts enforce them perfectly.

- Today we are looking at "procedural" aspects of law:
  - "Procedure" refers to how the court system determines liability and guilt – more generally, the set of rules defining rights and obligations of the players in a legal dispute.

- "Expectations damages" is a substantive rule; "beyond a reasonable doubt" is a procedural rule.

- "Civil procedure" is the set of rules guiding civil disputes; "criminal procedure" is the set of rules guiding criminal prosecutions.

Legal Process and Administrative Costs
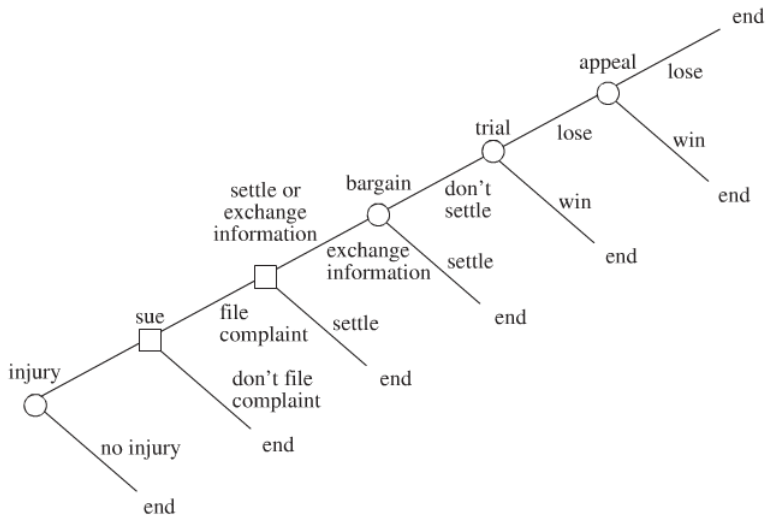
- Recall from the tort law lecture the question of "administrative costs":
    - The negligence standard is probably more expensive to administer than no liability or strict liability

- One important goal of civil and criminal procedure is to minimize the administrative costs of resolving civil disputes and determining criminal responsibility.

- Administrative costs include the costs to everyone involved in a legal matter, such as the costs of filing a legal claim, exchanging information with the other party, bargaining in an attempt to settle, attorney fees, police, judges, juries, appeals, etc.

- A useful approach is to assume that the economic objective of procedural law is to minimize the sum of administrative and error costs:

$$\min SC = c_a + c(e)$$

where

- c_a = administrative costs, that is, the total expenses by private parties and the state in resolving legal matters.
  - For example, if settling a case will obtain the same outcome as trial, but at lower cost, then settlement is preferred.
- $c(e)$ = the costs of court error e; errors reduce the incentive effects of substantive legal rules.
  - For example, a tort system that determines negligence liability at random would not impose efficient precautionary incentives.

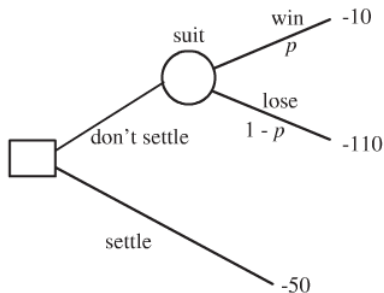- Judgement J for plaintiff if win, attorney takes 30%:
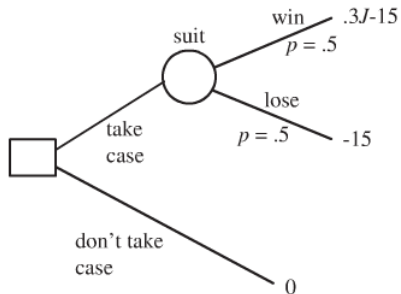
- What is the lowest expected judgement in which the lawyer takes the case?

- Plaintiff suffers harm of \$100, offers \$50 settlement; defendant's trial costs are \$10 and wins with probability p.

- When should the defendant settle?
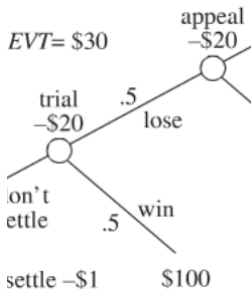
- Computing the expected value of a legal claim (EVC) requires backwards induction.
- So we start at the end, the decision whether to appeal:

$EVA = -\$10$

appeal $-\$20$ .9 $\quad$ $\$0$ lose

)se

win .1

$\$100$
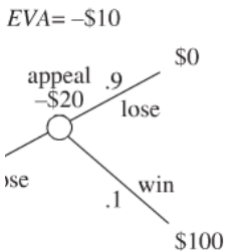
- A losing plaintiff pays \$20 to appeal, wins \$100 with probability 0.1.
  - The expected value of appeal (EVA) is \$-10
 - The rational plaintiff will not appeal.

- Moving backward, the decision whether to go to trial:

- A plaintiff who failed to settle out of court pays $20 to go to trial, wins $100 with probability 0.5.
    - We know from previous step that he doesn't appeal if he loses.
    - The expected value of trial (EVT) is $30
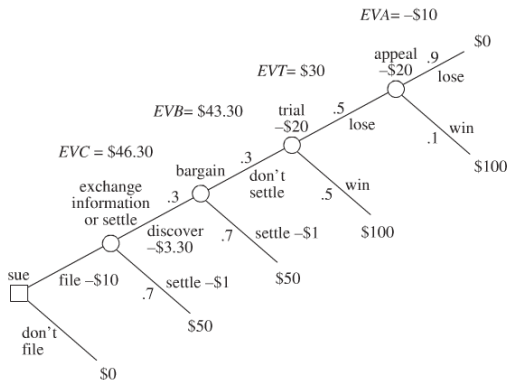   - If settlement fails, a trial occurs.

- Moving backward, the decision whether to settle after discovery:
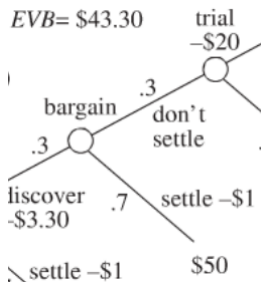
- A plaintiff who has completed discovery will bargain to a settlement of $50 (minus $1 settlement costs) with probability 0.7:

  - We know from the previous step that EVT=$30.

  - The expected value of bargaining (EVB) is

$$EVB = .7(\$50 - \$1) + .3(\$30) = \$43.30$$

EVA= –$10

EVT= $30

EVB= $43.30

EVC = $46.30

appeal .9 — $0 — lose
–$20 — .1 — win — $100

trial –$20 — .5 — lose
— .5 — win — $100

bargain .3
don't settle

exchange information or settle .3

discover –$3.30 — .7 — settle –$1 — $50

sue — file –$10
— .7 — settle –$1 — $50

don't file — $0

- Before discovery, settlement of $50 (minus $1 settlement costs) occurs with probability 0.7, and EVB=$43.30
  - The expected value of the claim at the time of filing is

$$EVC = 0.7(\$50 - \$1) + 0.3(\$43.30) = \$46.30$$

  - This is greater than the filing cost of $10, so the rational plaintiff files suit.

- Why don't parties always settle?
    - Because they have different beliefs about the merits of the claim
- In particular, if both the plaintiff and the defendant believe they will win, a trial will occur.

- Exchanging information (also called discovery or disclosure) is a way to overcome these different beliefs.

Motivation to share bad news

- The adversarial trial process rewards disclosure of information that corrects the other side's optimism, which promotes settlements.

- The parties are less likely to disclose information that helps the other side.

- This effect is stronger for voluntary disclosure than for forced disclosure.

- Disclosure helps with both administrative and error costs:
  - For administrative costs, it is cheaper for parties to share information in an informal voluntary process (relative to a forced legal process administered by a judge)

  - For error costs, the information (much of which is verifiable) improves party's beliefs and makes settlement better reflect the result from an actual trial.

Settlement bargaining

- Oftentimes, settlement can achieve the same outcome of a trial at lower cost.
  - This lower cost is the "cooperative surplus" from settling
  - The Nash bargaining solution will split this surplus.

- Settlements are more likely to occur when plaintiff and defendant have similar expectations about the outcome from trial and when they have low/similar transaction costs in resolving the dispute.

- However, if both parties are overly optimistic, then both parties expect to gain more from trial than they could gain from a settlement acceptable to the other side.
  - Then a trial will occur.

- The criminal law counterpart to settlement is the plea bargain.

  - The defendant pleads guilty to a lesser crime than what he is initially prosecuted for

  - The defendants avoids the risk of a longer sentence upon conviction at trial.
  - The prosecutor avoids the risk that the defendant receives no punishment

- But what is the prosecutor maximizing?

- Three types of trial costs:
    - Fees (lawyer fees, court fees, bribery, etc.)

    - Delays
        - In Los Angeles, for example, it takes three years to bring a case.
        - In India, it takes a decade.

    - Uncertainty (risk averse parties have to bear risk)

- Many lawyers earn their living by keeping people *out* of legal disputes.

- Settlement

- Arbitration

- Mediation

- Duels

Incentives of lawyers and judges

- The ideal incentive structure for lawyers aligns those incentives with the client – if the client wins, the lawyer should win.

- Judges in contrast should be independent – their payoff should not depend at all on the outcome of a case.
    - That way, they might as well choose the socially optimal outcome.

- Among other things, having independent arbitrators is a public good that gives parties efficient incentives for making contracts.

- Thus judges in most countries have political independence and tenure.

- In summary:
    - Judges have incentives to do what is right and easy
    - Lawyers have incentives to do what is profitable and hard

- Juries have comparable incentives to judges – their payoffs are supposed to be insulated from the outcome of the trial, so they might as well choose the social optimum.

- On the other hand, juries are paid next to nothing, so they probably have incentives to end trials as quickly as possible.

- Bribing a whole jury might be more costly than bribing a single judge.

- Juries probably care more about social norms or cultural beliefs about fairness, rather than formal law.

- In Britain, the loser of a lawsuit has to pay the other side's litigation costs, including attorney's fees.

    - They also have less litigation per capita in Britain.

- This is because the "loser pays" rule will discourage suits with a relatively low probability of winning.

- Some U.S. States have a rule called "offers to compromise," which will penalize a party who refuses to settle.

- In the United States like most jurisdictions, parties who lose at trial can appeal to a higher court to correct mistakes.

- Appeal can be mandatory or discretionary

- In the United States, appeals courts can usually review findings of law but not findings of fact.

- Hierarchical court systems enable the higher-tier judges to monitor the performance of lower-tier judges and correct their mistakes.

- This is a relatively low-cost correction system because litigants typically appeal only when there is a mistake.
  - The expected value of appeal is higher when the appeals court is likely to reverse.