11
Litigation, Settlement and the Market for Lawyers

11.1 Introduction

Chapter 3 examined situations in which parties to a dispute could potentially (if transaction costs were sufficiently low) negotiate over an economic outcome and, by doing so, exhaust all gains from trade. Moreover, under certain assumptions (for example, quasi-linearity of utility functions), the final outcome and the size of the aggregate gains from trade were independent of the initial allocation of property rights or legal rule than was in place. This is the essence of the Coase Theorem.

But how does this ‘negotiation’ or ‘bargaining’ process take place? And if parties always negotiate, why is it that even though the vast majority of disputes settle out of court, not all of them do? Haggling, threats, offers, counteroffers, proposals, objections, counterproposals, counterobjections are part and parcel of many economic transactions and most legal disputes. This chapter goes inside the ‘black box’ of the legal negotiation process and examines how bargaining rules and institutions may affect observed outcomes. The incentive to file lawsuits and settle out of court are also examined under various cost-allocation rules, with the English and American rules presented as special cases.

The chapter is structured as follows. Sections 11.2 and 11.3 study the two common approaches to bargaining that have been explored in the economic literature. Section 11.4 examines the economics of legal disputes and the gains from settling out of court, and explores some reasons why parties might go to court. Section 11.5 presents a general model of legal conflict which can be used to address a wide variety of questions around the economics of litigation. Section 11.6 applies this setup to the market for lawyers, and explores the efficiency properties of this market,
assuming that legal services are demanded solely for the purposes of redistributing existing resources. Section 11.7 explores a related but slightly different set of issues: legal complexity and variability, but reaches similar conclusions to the analysis in section 11.6. Section 11.8 returns to the set of questions presented back in Chapter 1, and explores the final issue outlined there: the common law efficiency hypothesis.

11.2 Legal disputes and the influence of bargaining rules and institutions on economic outcomes

Up to this point we have largely ignored the issue of how parties involved in Coasean bargaining might actually split the gains from exchange, and how rules around bargaining might affect the distribution of the gains from trade. But bargaining norms, rules and institutions are an important part of the legal landscape, and can have a considerable influence on economic outcomes. Moreover, the way in which the gains from settlement are distributed can send an important signal to those who may be involved in legal disputes in the future. For example, if bargaining rules provide for generous settlement terms for plaintiffs, then, ceteris paribus, this increases the gains to plaintiffs from filing lawsuits.

There is a well-developed body of economic theory, known as bargaining theory, which examines these issues. There are two broad approaches to modelling bargaining norms and institutions:

1. The non-cooperative bargaining approach starts out with a set of ‘rules of the game’, under which offers and counteroffers can be made by parties, and derives the bargaining outcome as the equilibrium of a non-cooperative ‘offer and acceptance’ game.
2. The axiomatic bargaining approach posits a set of axioms or which are ‘reasonable’ for a bargaining solution to possess, and then attempts to characterise these axioms in terms of bargaining solutions.

There are significant analytical differences between the two approaches. Remarkably, however, it turns out that there are often very close links between the outcomes that each approach predicts.

11.2.1 Legal disputes and non-cooperative bargaining theory

The non-cooperative bargaining approach models a situation in which offers and counteroffers can be made, as they would be in a ‘real world’ bargaining situation between parties haggling with each other during a legal dispute. The standard non-cooperative setup is as follows.