

Law and Economics: Law-making and Legal Process

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Overview

- ▶ Law-making: 'production perspective'
- ▶ Litigation & legal disputes
 - ▶ Trial vs. out-of-court settlement
- ▶ Role of lawyers
 - ▶ Principal-agent problem
- ▶ Process rules
 - ▶ Allocation of legal costs
 - ▶ Class actions

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Law-making: economic perspective

- ▶ Economics: limited ('scarce') resources
 - ▶ Including time, energy, information
- ▶ Law-making as 'production of (good) rules'
 - ▶ Preparatory machinery (bureaucrats, experts, lawyers)
 - ▶ Political process
 - ▶ Civil society (participation)
- ▶ Imperfect law
 - ▶ Bad rules
 - ▶ Inconsistencies
 - ▶ Uncertainties (e.g. ambiguous concepts)
 - ▶ Gaps (e.g. tax loopholes)

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'Regulatory lag'

- ▶ = *Reaction time* of legislation/regulation
- 1. **Observational lag**
 - ▶ Statistics and reporting
- 2. **Decision lag**
 - ▶ Different steps in legislative process
- 3. **Implementation lag**
 - ▶ Transition period before new legislation becomes effective
- 4. **Effect lag**
 - ▶ Learning time, adaptation of behaviour
- ▶ **Total regulatory lag = 1 + 2 + 3 + 4**

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Rule-creation options

- ▶ Laws properly so called (Acts of Parliament)
 - ▶ Heaviest & longest process
- ▶ Delegated law-making: Regulations
 - ▶ Lighter process
- ▶ Broad principles + specification by regulatory authorities
 - ▶ E.g. Financial market regulations, environmental regulations (expert knowledge, fast-changing regulatory environment)
- ▶ Broad principles + specification by courts
 - ▶ E.g. English tort law; Finnish financial markets law (some parts)
- ▶ Judge-made law ('common law')
 - ▶ E.g. English contract law (mostly)
 - ▶ Adaptation/reform problems + theoretical complexity?

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Litigation: decision to sue

- ▶ Suit: starting formal legal action
- ▶ Private incentives to sue: sue if *expected cost is less than expected benefits*
 - ▶ Legal costs (lawyers' fees etc.)
 - ▶ Loss of time and energy (often significant cost!)
 - ▶ Uncertainty
 - ▶ Probability of winning
 - ▶ Likely outcome/judgment

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Litigation: social desirable level?

- ▶ Misalignment:
 - ▶ Private costs and benefits of claimant
 - ▶ Defendant's costs + State's costs (not taken into account)
- ▶ Is there too much or too little litigation?
 - a) *Too much litigation*: social costs of suit
 - b) *Too little litigation*:
 - ▶ Deterrent effect (e.g. tort)
 - ▶ Law development: setting of precedent (e.g. financial markets law – a lot of uncertainty about interpretation)
 - ▶ Compensation of victims

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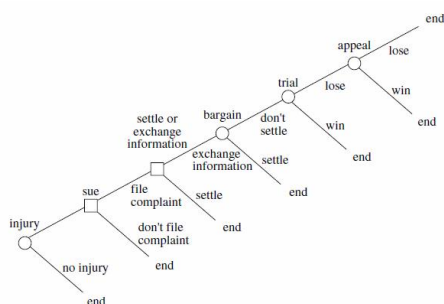
Amount of litigation: policy options

- ▶ Level of fees (e.g. court fees)
- ▶ Cost of legal services (e.g. lawyers' salaries)
- ▶ Subsidies (e.g. legal assistance)
- ▶ Summary process and 'small-claims track'
- ▶ Out-of-court settlement
- ▶ Alternative dispute resolution (ADR)
- ▶ Contingency fees
- ▶ Allocation of legal costs (e.g. each pays own vs. loser-pays-all)
- ▶ Class action

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Stages in a legal dispute (tort claim)



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Trial vs. settlement (example)

- ▶ Risk neutral actors (for simplicity here)
- ▶ Claimant's expectations:
 - ▶ Probability of winning: 70%
 - ▶ Judgment amount (if win): 100,000
 - ▶ Trial expenses: 20,000
 - ▶ *Minimum settlement amount*: $0.70 \times 100,000 - 20,000 = 50,000$
- ▶ Defendant's expectations:
 - ▶ Probability of losing (i.e. claimant winning): 50%
 - ▶ Judgment amount (if lose): 100,000
 - ▶ Trial expenses: 25,000
 - ▶ *Maximum settlement amount*: $0.50 \times 100,000 + 25,000 = 75,000$
- ▶ Settlement amount = between 50,000 – 75,000.

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Trial vs. settlement (simple model)

- ▶ Claimant's minimum acceptance settlement price:

$$S_c = p_c w_c - c_c$$

- ▶ Defendant's maximum acceptable settlement price:

$$S_d = p_d w_d + c_d$$

- ▶ Settlement condition:

$$S_c \leq S_d$$

$$p_c w_c - c_c \leq p_d w_d + c_d$$

$$p_c w_c - p_d w_d \leq c_c + c_d$$

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Trial vs. settlement: analysis

- ▶ Agreement on outcome: $p_c w_c = p_d w_d$
 - ▶ → always settle (escape trial costs!)
- ▶ How much can expectations diverge that settlement is still attractive to both?
 - ▶ → Up to level of (expected) trial costs: $c_c + c_d$
- ▶ Obstacles:
 - ▶ Overconfidence bias (very common!)
 - ▶ Lack of sharing of evidence & legal argument
 - ▶ Client vs. lawyer: conflict of interests?

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Trial vs. settlement: variables & policy options

- 1) **Expectations about winning/losing (p)**
 - ▶ Information sharing (may be made compulsory: *discovery*)
 - ▶ Segmented trials
 - ▶ Pre-trial mediation (creates objectivity)
- 2) **Judgment amount (w , assume it is the same)**
 - ▶ Large claims → trial more likely (c relatively smaller)
- 3) **Legal expenses (c)**
 - ▶ High lawyer salaries → settlement more likely
 - ▶ Complex cases → settlement ...
 - ▶ Appeals prospect → settlement (no appeal!)
 - ▶ Legal insurance and contingency fees → trial

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Trial vs. settlement: risk aversion

- ▶ **Risk aversion → favour settlement!**
 - ▶ Large claims (w)
 - ▶ Complex cases (c)
 - ▶ Individual persons and small companies
- ▶ **How many cases are settled?**
- ▶ **USA data:**
 - ▶ State courts: 96% settle
 - ▶ Federal courts: 98% settle



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Alternative dispute resolution (ADR)

- ▶ **Arbitration ('private court')**
 - ▶ Faster
 - ▶ No appeals (faster + lower legal costs)
 - ▶ No publicity: avoid reputation costs
 - ▶ No subsidy (e.g. court fees) → can be more expensive
 - ▶ No precedent → loss of positive externality (social cost)
- ▶ **Mediation ('assisted negotiation')**
 - ▶ Relationship-preserving
 - ▶ Assisted information exchange → easier to settle

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Lawyers: production perspective

- ▶ **Division of labour**
 - ▶ Specialisation
 - ▶ Investment in knowledge, skills, contacts
 - ▶ Superior information on legal requirements, outcomes of cases
- ▶ **Types of legal work**
 - ▶ Barrister / court-room lawyer (represent clients)
 - ▶ Solicitor / office lawyer (advising clients, drafting documents)
 - ▶ Far majority of legal work
 - ▶ Independent vs. In-house counsel

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Lawyers: remuneration & incentives

- ▶ **Classic principal-agent problem**
 - ▶ Moral hazard / incentive problem
- a) **Hourly fee**
 - ▶ Accept any case
 - ▶ Prefer to fight long and 'work too much' (trial, not settle)
- b) **Contingency fee (USA) / conditional fee (England)**
 - ▶ = 'No win no fee' (victory: percentage of judgment amount)
 - ▶ Screening: accept promising cases only
 - ▶ Prefer large cases
 - ▶ *Effective hourly rate fall over time* (lawyers bears all litigation costs, only gets a percentage)
 - ▶ → Prefer to settle early

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Remuneration: risk aversion

- ▶ **Risk-averse lawyers: prefer hourly fees (ceteris paribus)**
 - ▶ Contingency fees: add *risk premium*
 - ▶ Large law firms have competitive advantage (risk-pooling)
- ▶ **Risk-averse clients: prefer contingency fees**
 - ▶ But may be willing to pay a risk premium
- ▶ **Implications:**
 - ▶ Normal individuals and small businesses prefer *contingency fees* (and will sue only if they are available)
 - ▶ Big businesses and wealth individuals prefer hourly fees (no risk premium = lower price) + get better quality work?
- ▶ **Data: use of hourly fees (USA)**
 - ▶ Businesses: 81% of cases
 - ▶ Individuals: 10% of cases

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Lawyers: cost rules

- ▶ USA: *each party pays its own* ('American rule')
 - ▶ Exception: decline settlement and fail to win more in court → may have to pay all costs
- ▶ England & Commonwealth: *loser pays all fees* ('English rule' or 'fee shifting')
 - ▶ Exception: offer to settle (declined) → only pay part of costs
- ▶ Risk-aversion and fee shifting
 - ▶ May deter litigation
 - ▶ Theoretically, fee-shifting resembles contingency fee effect (net outcome depends more on success, *ceteris paribus*)

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Class action

- ▶ Available in USA
- ▶ Introduced in Finland
 - ▶ But not available for securities litigation (why?)
- ▶ Group of claimants: 'a class' (e.g. mass externality)
 - ▶ Incentive problem: small personal claim vs. high legal costs
 - ▶ Coordination problem
 - ▶ Free rider problem
 - ▶ → class action: sue on behalf of many (others can join in)
- ▶ Alternative: legal aid?
 - ▶ Only small amounts
 - ▶ Means tested (really addresses a different issue!)

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Lawyers: competitive market

- ▶ Competition for work, bidding
- ▶ Reputation and on-going relationships
- ▶ → better quality service (principal-agent problem)
- ▶ Challenges:
 - ▶ Availability of information on quality (comparisons, contacts)?
 - ▶ Client type: one-off or frequent buyer?
 - ▶ Market regulations: advertising limitations?
 - ▶ Advertising legal services used to be prohibited in Finland. Why?

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Legal market: number of lawyers

- ▶ USA: 1.25% of GDP spent on legal services
- ▶ Q: Which country has most lawyers per capita?
- ▶ A: USA (1 for every 265 Americans)
 - ▶ Brazil (1/326)
 - ▶ Spain (1/395)
 - ▶ UK (1/401)
 - ▶ Germany (1/593)
 - ▶ France (1/1403)
- ▶ Article of interest (not required reading): Markesinis, "Litigation mania in England, Germany and the USA: Are we so very different?" *Cambridge Law Journal* 49, 233-276 (1990)

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Some lawyer jokes

- ▶ "When I was the only lawyer in Shinbone, I almost starved. Now that another lawyers has come to town, I eat steak, and I'm building a new house."
- ▶ "Litigation is like wrestling with a pig: you both get dirty, and the pig enjoys it."
- ▶ "The first thing we do – let's kill all the lawyers." (William Shakespeare, *Henry VI*, Part 2, Act 4, Scene 2)



Q: Why won't sharks attack lawyers?
A: Professional courtesy.

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Reading

- ▶ Cooter & Ulen, chapter 10

+ Newspaper articles:

- ▶ "First Kill the Lawyers..."
 - ▶ http://money.cnn.com/magazines/fsb/fsb_archive/2004/04/01/366651/index.htm
- ▶ "Law in Japan"
 - ▶ <http://www.davidappleyard.com/japan/jp5.htm>

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