Nuisance Suits

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Abstract

Nuisance suits can be defined a number of ways, explained a number of ways, and prevented in a number of ways. I survey them for the forthcoming *New Palgrave Dictionary of Economics and the Law*, London: Macmillan Press, Peter Newman, editor.

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[1]xxx Footnotes starting with xxx are my notes to myself for revisions.

One of the chief problems of court reform in recent years has been the nuisance suit or frivolous suit. I will define this as *a lawsuit with a low probability of success at trial, brought even though the plaintiff knows that his probability of prevailing would not justify his costs if the judicial process were to be completed instantly.* This is one of many possible definitions, and, as we will see, trying to define the term helps to illuminate a variety of problems that arise in the courts. Note too that I have chosen a definition which depends on existing law and procedure; a filing that is a nuisance suit in one jurisdiction might win in another.

Let us begin with a model of a civil suit in tort. The plaintiff pays amount F to file suit against the defendant, an amount meant to include all initial expenses. The suit has probability α of prevailing and winning damages of D, facts known to both sides and the court. The plaintiff then makes a take-it-or-leave-it offer to settle for amount S. If the defendant rejects, the plaintiff decides whether to go to trial at additional cost c_p or to drop the suit. If he goes to trial, the defendant must pay c_d to defend himself. What makes this a nuisance suit is that $-F - c_p + \alpha D < 0$. In the extreme, the suit has no chance of winning, and $\alpha = 0$. This is essentially the model of Shavell (1982). (Note that all results below will carry through with more elaborate settlement bargaining and when the parties are uncertain of the parameter values.)

(1) Settlement extortion. One misconception can be dispelled immediately: the idea that the plaintiff can extract a settlement from the defendant simply because the defendant has greater costs of going to trial.

Suppose that c_d is large, much larger than c_p, and $c_p > \alpha D$. What will the settlement amount be?

The value to the defendant of not going to trial is $\alpha D + c_d$. The value to the plaintiff of going to trial is $\alpha D - c_p$. One might think that the settlement would be between these values– at the upper extreme, $\alpha D + c_d$, with take-it-or-leave-it offers; or $\alpha D + (c_d - c_p)/2$, with equal bargaining power. That is false. The catch is that the plaintiff's threat to go to trial must be credible, but if his settlement offer is turned down, he will give up rather than pay c_p for a probability α of D. Hence, the size of c_d is irrelevant.

There are, however, twists to the situation that can make the plaintiff's threat to go to trial credible, so suit-for-settlement becomes plausible.

Sunk Costs. Suppose the plaintiff has sunk most of his costs up front. Even though this is a nuisance suit, so $c_p + F > \alpha D$, it can also be true that $c_p < \alpha D$. Then, the threat to go to trial is credible, once the plaintiff has paid F, and if c_d is large, a big settlement can be extorted.

Both F and c_p may be small in terms of opportunity cost, if not accounting cost, because the plaintiff has pre-paid most of his legal costs. This could occur, for

example, when the plaintiff pays a flat salary to his in-house counsel, though only if he has no other use for the counsel's time. Pre-payment could, however, be a strategic move, reversing the typical advice to delay payments and hasten receipts. Making the cost F irrecoverable, the plaintiff's threat to go to trial becomes credible and his bargaining position improves.

The first model in which the timing of costs was crucial, Rosenberg and Shavell (1985), has a slightly different twist. After the plaintiff pays F, the defendant must pay c_d before the plaintiff pays c_p, because the defendant must prepare some defence to the initial filing or lose by summary judgement, whereas the plaintiff can rest on the merits until the actual trial. This means that the plaintiff can offer to settle for c_d immediately after filing, and the defendant will accept, even though both know that the plaintiff would never go to trial.

US federal independent prosecutors illustrate the importance of pre-paid costs. They have liberal budgets– indeed, no fixed budgets at all– so it is not surprising that their results have been poor by comparison with regular prosecutors. Since the client has authorized the expenditure in advance, before the quality of the case is determined by the prosecutor, the prosecutor has little incentive to drop cases that are unlikely to win at trial.

It is worth noting as an empirical matter that even if a case is frivolous, the defendant is often well advised to make heavy expenditures in defending himself. An apt case is *Bonsignore v. City of New York*, 521 F. Supp 394 (SDNY 1981). The wife of a policeman successfully sued the city after he shot her, claiming the city was negligent in not requiring all policeman to take tests for mental disorders. Judge Sofaer upheld the jury verdict, noting with disapproval that the city had brought no witnesses, whereas Mrs. Bonsignore had brought fifteen.

Divisible Costs. Bebchuk (1996) carries the idea of sunk costs further. Suppose that the plaintiff cannot pay his legal expenses first, but both sides incur costs in T stages, and at $T-1$, once most costs are sunk, the plaintiff finds it worthwhile to incur the costs of the last stage so as to have a chance at the trial judgement. He can then extract a settlement. Going back to $T-2$, however, the plaintiff would be willing to pay expenses of that stage, as the price of admission to the profitable settlement of $T-1$. The reasoning continues back to Stage 1. The result is like the loser-pays "dollar auction" of Shubik (1971), with settlement as an agreement by both players to exit a costly rivalry that is profitable at each stage but ruinous overall.

Defendant Ignorance. Bebchuck (1988) points out that if the plaintiff knows $\alpha = 0$ but the defendant does not, the plaintiff can bring suit and extort a profitable settlement. What is relevant to the defendant's acceptance of a settlement offer is the defendant's subjective probability of winning, not the plaintiff's, nor the true probability. Even if the defendant is uncertain of the probability, and assigns positive probability to the plaintiff dropping the case if no agreement is reached, the partially

credible threat is still credible, if not quite as frightening.

The defendant's disadvantage can arise from two sources. He might literally have worse information, especially before the discovery process begins. Before discovery, the tort defendant usually has little evidence available with which to dispute the plaintiff's claims. Or, he might not know the law, especially before he hires a lawyer. Many stories exist of government regulatory claims of this kind. The agency claims a violation where it knows none exists, threatening prosecution unless the defendant's behaviour is changed. Note that such suits are never actually filed in court (though the plaintiff still incurs costs), and hence court reforms cannot help.

Incomplete Information about the Plaintiff. With positive probability, the plaintiff might be irrational or motivated by one of the reasons under heading (2) below. All types of plaintiff will pretend to be of this litigious type. Suppose there is a probability β that the plaintiff will go to trial even though $c_p > \alpha D$. The defendant's expected cost from turning down the settlement offer is then $(1 - \beta) * (0) + \beta(\alpha D + c_d)$. Thus, the plaintiff can make a settlement demand of $\beta(\alpha D + c_d)$, which might well exceed F, even if it is much smaller than c_d.

Plaintiff Reputation. The plaintiff might want to maintain a reputation for carrying out threats. If there is even a very small probability that the plaintiff is irrational– much smaller than necessary as a base for the reason discussed in the previous paragraph– the plaintiff can use it for leverage to support a reputation equilibrium in the style of the Kreps-Milgrom-Roberts-Wilson (1982) "Gang of Four" model. For explanation of this subtle model, see chapters 5 and 6 of Rasmusen (1994). The essential requirement is that the plaintiff expects to be in future litigation and is willing to take a loss on the present case to preserve his reputation.

(2) Reasons not involving settlement. Other nuisance suits seem to exist which are not brought solely in the hopes of extorting a settlement (though a generous settlement is always welcome).

Plaintiff Mistake. The plaintiff may not know α is low. Mistakes always occur. In a sense, either $\alpha = 0$ or $\alpha = 1$, and any suit that loses is a nuisance suit, ex post. I will only mention two of the many reasons for mistakes. 1. A man is not just a poor judge in his own case, but often a sincerely poor judge, unable to see what is obvious to others: that his suit is hopeless. This is the origin of the "empty-head, pure-heart" suit. 2. The plaintiff faces an agency problem, because he relies on an attorney's advice. If the attorney is paid an hourly wage, he has incentive to convince the plaintiff to sue– which is, of course, a major reason for contingency fees, though their dampening effect on the number of nuisance suits is little noted (and even reversed, somehow, in the *Restatement of Torts* §675h). One-third of zero, plus a reputation for losing cases is not attractive to ambulance chasers.

Benefits from Litigation. It may happen that there is a benefit just from bringing

the case– the litigation cost C is negative. The *Restatement of Torts* , §676 (Propriety of Purpose) has a good discussion of this. The plaintiff may derive utility from the disutility of the defendant– a grudge suit. The plaintiff may value the publicity, as is commonly suspected of public prosecutors who bring sensational but legally dubious civil or criminal suits. (This is distinct from wanting a reputation for toughness for use in other court proceedings, discussed above.) The plaintiff may value the delay that litigation brings. If the suit includes a preliminary injunction, or if the plaintiff can win with a biased lower court even if he knows he will lose on appeal, he is able to delay something costly, e.g., suffering the death penalty. In civil cases, defendants may be able to delay yielding up property or complying with rules. Also, especially in land-use disputes, delay may enable a litigant to lobby to change the relevant law to his advantage.

Indirect Benefits from Winning. An apparent nuisance suit may turn out not to be one when indirect benefits to success are included. These include the utility of official vindication of one's cause, and advantages in later legal proceedings. Failure to prosecute patent and copyright infringement can waive the protection, and similar losses of rights occur in other areas of the law. An appellate victory can establish a precedent that a plaintiff can use in future litigation, or which changes the law in a way that he finds personally satisfying.

Court Error and Unjust Law. A somewhat different explanation for meritless suits is court error (distinct from defendant error, one of the earlier reasons). Even it is true that α *should* be zero, it may be that α is positive because of court error. Many suits that appear ridiculous do win, but while one is tempted to call these nuisance suits, they do not fall under the definition of this article. A suit may be a long shot and still have positive net expected value. In *Bigbee v. Pacific Tel.*, 34 Cal. 3d 49 (1983), for example, a man in a telephone booth sued the phone company for improper design and maintenance because it was hard to escape as a drunk driver careened towards him out of the street, over a kerb, and across a parking lot. The California Supreme Court unanimously upheld his right to a jury trial. Defending this suit against summary judgement was clearly not frivolous; it won by a large margin, and hence is not a nuisance suit. The problem is not procedure, but substance, and the proper derogatory term is "court error" or "unjust law," depending on whether other courts would replicate the same bad result. Such suits, however, may make up the bulk of what the public complains of as nuisance suits, as I explain in Rasmusen (1995), and are hard to remedy by procedural reform, as Bebchuck & Chang (1996) explain.

Any of this second set of reasons to go to trial can be leveraged up by the possibility of settlement. Once the threat to go to trial is credible, the the plaintiff can demand a bigger settlement, the prospect of which makes filing suit in the first place more attractive.

Note also that the second set of reasons does not arise only under the adversarial system of civil litigation. They apply to government-sponsored criminal and civil suits as well as to suits brought for profit. The problem of nuisance suits extends beyond common-law countries and beyond a profit-seeking plaintiff's bar.

Solutions. The goal of reducing the number of nuisance suits is often confused with the entirely separate, and dubious, goal of reducing litigation. A reform such as the English Rule, which leads to lower costs for meritorious plaintiffs, could actually increase the total amount of litigation. For efficiency and justice, this is good; for minimizing court caseloads, it is bad.

Fee-Shifting Rules. The American rule is that each litigant pays his own legal fees, except in unusual cases such as those covered by the Civil Rights Attorney's Fee Award Act of 1976, where plaintiffs can recover their costs, and in the state of Alaska (see Wade 1986: 487). The English rule is that the loser pays. There is a large literature in economics on this, surveyed in Cooter and Rubinfeld (1989). By reducing the payoff at trial, the English Rule reduces the credibility of threats to go to trial with meritless suits.

Procedural Rules. These rules delegate the deterrence of nuisance suits to the judge in the original proceedings, subject to review by higher courts.

First, the rules on how suit is brought can make nuisance suits difficult. These include rules on standing, limiting who can bring suit; on forum shopping, preventing plaintiffs from going to sympathetic or corrupt judges; on removal, allowing defendants to avoid such judges; on pleadings, requiring a specific-enough filing that its lack of merit is apparent; on evidence, barring hearsay and limiting expert testimony; and on discovery, limiting the demands each litigant can impose on the other. See Olson (1991) (for America), and the Woolf Report (1996) (for England and Wales) for discussion of these rules, highly legalistic and largely ignored by economists. Given these rules, the judge has the ability to dismiss suits by summary judgement.

Second, the judge can punish as well as dismiss. Courts have inherent powers to control bad-faith conduct, and the US Supreme Court has on this basis upheld sanctions even for acts outside the courtroom. *Chambers v. Nasco*, 501 US 32 (1991). In addition, judges are often granted statutory powers. The Federal statute 28 USC. §1927 allows fee-shifting under certain circumstances, Federal tax rule 26 USCS §6673 assesses penalties for frivolous or dilatory proceedings, and many states have similar statutes. The best-known sanction in the United States is Rule 11 of the Federal Rules of Civil Procedure, as amended in 1983. It says, in the concise 1983 version (expanded less elegantly in the 1993 amendments) that an attorney may only file suit if

"...to the best of his knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or

> a good faith argument for the extension, modification, or reversal of existing
> law, and that it is not interposed for any improper purpose, such as to harass
> or to cause unnecessary delay or needless increase in the cost of litigation."

Imposition of Rule 11 sanctions is common, but although the 1993 amendments, the Supreme Court, and many economists have emphasized that its purpose is deterrence, lower courts seem to pay little attention. They tend to use the sanctions for compensation to the aggrieved party, and only after a motion by that party. See *Cooter & Gell v. Hartmarx*, 496 US 384, 393 (1990), Polinsky and Rubinfeld (1993), and, for further analysis of the 1993 amendments, Kobayashi & Parker (1993).

It is frequently observed that a good rule can be bad policy when applied by uncooperative judges. Judges often condone, or even praise, aggressive litigation. See *Golden Eagle v. Burroughs*, 801 F.2d 1531 (9th Cir., 1986) and *Zaldivar v. City of Los Angeles*, 780 F. 2d 823 (9th Cir., 1986), which admire Rule 11 in the abstract while overruling it in particular cases, or *Eastway v. City of New York* , 637 F. Supp. 558 (E.D.N.Y 1986), in which an unhappy trial judge required by an appellate court to impose Rule 11 sanctions decided to include only attorney's fees, and to reduce them from $58,550 to $1,000 because of mitigating factors. Perhaps as a surrender to this kind of judge nullification, Rule 11 was amended in 1993 to say that the trial judge *may* rather than *shall* impose sanctions. More study needs to be done of judges' motives, both personal and political; Macey (1994) is one step in this direction.

Tort Rules. If legislatures and judges are unwilling to stop nuisance suits, the public might be able to rely on the plaintiff's bar, resorting to judo tort reform which uses the opponent's strength and momentum against him. A nuisance suit is an injury, often intentional, and reckless by definition. Can the victim sue?

Economists have not addressed this topic, but Wade (1986) has an excellent survey of state law. Judges have been uniformly hostile to suits brought on general tort grounds of negligent harm, but this is perhaps because of the existence of special causes of action for malicious prosecution, both criminal and civil. What their effect has been is unclear, but suits for civil malicious prosecution lose much of their force in the absence of the English Rule on costs, unless they can obtain punitive damages as in *Bertero v. National General Corp.*, 13 Cal. 3d 43 (1975).

Conclusion. Law-and-economics research in the area of nuisance suits has been active since the early 1980's, but though it has illuminated extortionary settlement and the effects of fee-shifting, it has neglected many other aspects of the problem. Perhaps the biggest blanks are in the areas of public choice theory and theory-driven empirical study. Reforming a system against the inclinations of those who staff it is no easy problem, but scholarship has concentrated on the effect of successful proposals rather than implementation. The incentives of litigants are studied in great detail; the incentives of judges, not at all. Empirical work would also be helpful, particularly

to delineate the extent of the problem and which of the many plausible explanations for nuisance suits are most common in practice.

STATUTES

28 USC §1927 (fee-shifting under unusual circumstances)

USCS Fed Rules Civ Proc R 11 (1996), Federal Rules of Civil Procedure §11 (sanctions for frivolous suits)

26 USCS §6673 (1996) (tax court sanctions for frivolous suits)

42 USC 1988, Civil Rights Attorney's Fee Award Act of 1976 (plaintiffs can recover their costs) .

CASES

Bertero v. National General Corp., 13 Cal. 3d 43 (1975) (punitive damages can be assessed for malicious civil prosecution)

Bonsignore v. City of New York, 521 F. Supp 394 (SDNY 1981) (wife shot by policeman sued city)

Bigbee v. Pacific Tel., 34 Cal. 3d 49 (1983) (suing the telephone booth maker)

Zaldivar v. City of Los Angeles, 780 F 2d 823 (9th Cir. 1986). (extent of frivolity that requires Rule 11 sanctions)

Golden Eagle v. Burroughs, 801 F2d 1531 (9th Cir. 1986) (false statements per se cannot be sanctioned by Rule 11)

Eastway v. City of New York , 637 F. Supp. 558 (E.D.N.Y 1986)

Cooter & Gell v. Hartmarx Corp., 496 US 384 (1990) (Rule 11 is meant to deter)

Chambers v. Nasco, Inc., 501 US 32 (1991) (inherent court powers)

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Notes for the Editor

Crossfile under:

FRIVOLOUS SUITS.

RULE 11.

PROCEDURE.

SETTLEMENT.

JUDICIAL INDEPENDENCE

MALICIOUS PROSECUTION.

This draft has 3244 words in main text and 584 words in the bibliography.

Suggested length: 3000 words plus up to 450 for bibliography.

I could cut out the paragraph on independent prosecutors and the parenthetic explanations of the meaning of cases.