RISING LEGAL COSTS

Robert E. Marks

in Russell Fox,
Justice in the Twenty-First Century,
London: Cavendish Publishing, 1999.
(Chapter 15)

1. Costs of Litigation

A continuing, oft-expressed concern about the legal system, in the English-speaking world at least, is the rising cost of legal services, whether civil or criminal. Given the labour-intensive nature of legal services, this is not surprising to an economist, as we discuss below. In order to be effective, policy must be informed before reforms are considered, lest reforming zeal be dissipated ineffectually.

This is underlined by J. Michael McWilliams (1992), then President of the American Bar Association, writing in a special issue of *Business Economics* devoted to the costs, both out of pocket and in delays, of civil litigation in the U.S.A. He argued that, whether lawyers or business economists, advisors of those who must make decisions involving future activities "must be able to predict the consequences of their choices in order that they [the advised] may act with fiscal prudence, legal correctness and moral propriety. Both the passage of excessive time between event and resolution and the accrual of excessive costs to vindicate a course of action render the predicted consequence less palatable and less certain" (pp. 19–20).

In another paper in the special issue, Hoadley (1992) argues that in the U.S. the direct and indirect costs of litigation including damage awards had reached such a level that they could "no longer be ignored or downplayed by business economists in their analyses and forecasts" of the U.S. economy. He believes that the accompanying burdens on managerial planning and decision time are reducing American productivity and competitiveness.

Hoadley gives several reasons (p. 10) for the heavy use of the legal system in the U.S.:

1. Absence of cultural determination to resolve disputes privately;
2. Someone else must be to blame for one's misfortune;
3. Minimum cost risks for plaintiffs. This is not so in Australia, where the loser bears all legal costs, as well as paying any damages awarded;
4. No cost incentives for defendants to settle out of court;
5. Contingent fee arrangements with clients. This is a recent introduction into Australian litigation;
6. Prospects of punitive damage awards;
7. Unrealistically high expectations of perfection from others;

8. The world of business is getting markedly more complicated;
9. The use of discovery as a "fishing expedition". Discovery can impose heavy costs on a defendant.
10. Predatory opportunities through narrow legal specialisation;
11. An overabundance of high-fee-seeking lawyers soliciting clients; and
12. The availability of word processing that expedites the filing of ponderous lawsuits.

As has been discussed in other chapters of this book, many of these factors are to be seen in Australia as well; indeed, in some respects such as contingent fees we are moving towards the U.S. practice.

Hoadley focusses on the issues of product liability and the producing firm as defendant, which may not be such an issue in Australia, but some of his concerns should be ours. Of course, his list of factors are reasons why litigation may occur, rather than a discussion of the costs of the litigation process once begun. It is true that the decision to engage in litigation is the first step, and that reducing the level of litigation, ceteris paribus, will reduce the total costs associated with a nation's litigation, but we are concerned here with ways of reducing the costs, both direct and indirect, of litigation.

To that end we discuss several papers that have examined aspects of the costs of litigation in Australia and abroad, and then discuss the long-term cost pressures that will continue, without drastic reforms. Williams & Williams (1994) examine the costs of Australian civil litigation in two states, over a period during which a reform to reduce the duration of litigation was introduced. Hughes & Snyder (1995) examine a natural experiment in Florida which clarifies the effects of the Anglo-Australian rule that the loser pays all the legal costs. Kingston (1995) presents data on another natural experiment in the U.S. on compulsory expert arbitration, with legal aid to the party that does not appeal the ruling.

1.1 Costs of Civil Litigation

Empirical studies on legal costs are rare, but Williams & Williams (1994) provide an insight into the costs of civil litigation in the two Australian states of Victoria and Queensland. This study, sponsored by the Australian Institute of Judicial Administration, collected and interpreted data that would throw light on the following questions:

1. By how much do costs increase at each stage of the litigation process? This information highlights where the greatest potential for cost savings arises.
2. Does the quality of legal inputs expedite settlement, or can some work be done just as effectively by junior (and so cheaper) professionals?
3. Does the mere effluxion of time raise costs? If so, then this points towards case-flow management.
4. Are larger and more experienced law firms more efficient than smaller ones? If so, then this points towards specialisation as cost-effective.
5. What are the costs of nonlegal labour inputs, such as expert witnesses, relative to legal costs?
6. To what extent do costs and procedures vary according to the type of case? Is it possible to transfer procedures from the more efficient types of case to others?

Because the project was concerned with costs rather than charges, information was gathered on the hours of labour inputs. Litigation was categorised by: types of case, seniority of the lawyer, stage of the litigation process, and the duration of the activity, as well as by non-labour inputs.

For this monograph the relevant questions are numbers 1, 2, 3, and 5 above. The other two questions, although important, are beyond the reforms suggested in this study.

There were 56 Victorian solicitor firms and 283 cases and 53 and 206 Queensland firms and cases respectively. The bulk of the civil litigation was for personal injury claims of up to $100,000 for damages in common law.

1.1.1 Firm costs

In Victorian personal injury cases the only significant determinants of firm costs were, first, the stage of disposition and, second, the experience of the firm in plaintiff cases. Cases settled at the door of the court or during the trial used 45 percent more inputs (viz. partners, salaried legal staff, other salaried staff, and all other expenditure) than did cases settled earlier' and cases that went to verdict required 380 percent (i.e. 3.8 times) more resources than did cases that did not go to court. For causes cases in Victoria, if the case went to verdict, then the firm costs were almost three times higher.

In August 1988, new rules that imposed tight constraints on the time within which particular procedures had to be completed were introduced into causes cases by the County Court in Victoria. The data show that the rules reduced the time taken, without significantly raising (or lowering) costs. Indeed, once the stage of disposition was allowed for, time did not affect costs, which implies that ADR programmes, if accepted early in the course of the case, have the potential to reduce costs.

In Queensland personal injury cases, costs were significantly influenced by, first, stage of disposition and, second, time taken, inter alia. If the case went to verdict or was settled during the trial, firm costs were on average just over double those of cases settled without going to court. Each additional six months the case takes is stimated to raise the costs by 7 percent.

1.1.2 Solicitor Inputs

For both states, in personal injury cases the average time input of solicitors increased from 17 hours for those settled at a pretrial conference, to 25 hours for those settled at the door of the court, to 62 hours for those that went to verdict.

Solicitor inputs into causes cases were much higher than for personal injury cases: almost double in Victoria for cases disposed of at the same stage.

1.1.3 Disbursements

In their data, Williams & Williams found that disbursements were divided between costs of baristers, payments to expert witnesses (in injury cases, primarily medical reports), and other office outlays. As with firm costs, the stage of disposition is the most important determinant of disbursements: in Victoria, personal injury cases that went to trial had disbursements nearly five times those of cases settled at pretrial conferences or soon after. For causes cases, the new rules introduced in August 1988 did reduce disbursement costs.

In Queensland, if a permanent injury case reached at least the door of the court, then disbursements were about four times those for cases settled earlier, and for debt and causes cases two or three times greater.

1.1.4 Total Costs

Total costs are firm costs plus disbursements. Williams & Williams found no evidence of substitution between firm costs and disbursements, and so the significant determinant of firm costs and disbursements were also significant for total costs. They found that the major influence on cost is the stage of settlement. In particular, the costs of going to trial are very high. The costs of personal injury cases that settled at the pretrial conference were between 25 percent and 37 percent of those that went to verdict.

Williams & Williams survey the literature on why parties will settle a dispute rather than relying on a judge to make a decision (Landes 1971; Gould 1973; Priest & Klein 1984). The closer the predictions of the parties about the outcome of a court hearing, the greater the likelihood of settlement. Williams & Williams suggest that, in consequence, exchange of as much information as early as possible in the dispute will promote settlement. Any steps that concentrate the minds of the parties early in the dispute are to be encouraged. They found little evidence, however, that the use of senior solicitors in the early stages would expedite settlement.

Case-flow management describes the influence of the court over the rate at which the case proceeds. Williams & Williams find that the effectiveness of case-flow management at reducing costs depends very much on the type of case: in personal injury cases, those cases that took longer to reach the pretrial conference had a greater probability of settling then, while the time taken was not a significant determinant of costs, at least not in Victoria. On the other hand, the new Victorian rules for causes cases seem to have expedited disposition without raising costs, or without reducing them significantly either.

The most surprising finding of Williams & Williams from the cost data was the high cost of expert reports, in particular medical reports and witnesses in personal injury cases. These costs could be reduced by the introduction of limits on the numbers of reports permitted and witnesses called, as well as requiring early disclosure of medical reports.

1.2 English versus American Rules for Costs

In contrast to the American rule, whereby each party bears its own costs, the English rule requires losers at trial to pay the winner's legal fees, up to a reasonable limit. Hughes & Snyder (1985) develop six hypotheses regarding how these two cost-allocation rules might affect settlements and litigated outcomes through changes in, first, the selection of cases reaching the settle-versus-litigate stage and, second, behaviour thereafter. Using data from Florida, which applied the English rule to medical malpractice claims during the period 1980–85, they examine the rules' effects on the probability of plaintiffs' winning at trial, jury awards, and out-of-court settlements. The English rule increased plaintiff success rates at trial, average jury awards, and out-of-court settlements. Hughes & Snyder's interpretation of these findings emphasizes that the overall quality of the claims reaching the settle-versus-litigate stage must improve to generate the combination of effects observed.

1.3 Compulsory Expert Arbitration and the Costs of Litigation

An important reason why intellectual property is far less effective for generating innovation than it could be is the excessively high cost of resolving disputes. This largely reflects the use of ordinary court arrangements to determine what are essentially technical issues. Kingston (1995) proposes an alternative: compulsory expert arbitration, with

legal aid for the party that does not appeal to the court from a ruling. He shows that a full-scale working model of such a system exists in the interference procedure of the United States Patent and Trademark Office. He notes that no more than 4 percent of court appeals from decisions in this are even partially successful and argues that this augurs well for the potential value of such a scheme of compulsory expert arbitration.

2. Rising Labour Costs and the Cost of Litigation

Since Adam Smith, over two hundred years ago, economists have divided firms' outputs into material products (tangibles) and services (intangibles). Smith himself saw services as a hindrance to the production of material goods, and so classified the labour that went into the production of services as "unproductive" labour, whereas the labour that helped produce tangible things was productive. (This discussion has been helped by Delaunay & Gadrey (1992).)

Influenced by Smith, Karl Marx recognised that some services (transport, communication, and maintenance and repairs) were productive, since they altered the material form of things, but all other services (including commercial labor, engaged in wholesale and retail trade; financial labor, engaged in finance, insurance, and real estate; and government labor, involved in the maintenance of law and order) were unproductive in his view and the labour employed in these activities was therefore unproductive too.

In the marginalist revolution the neoclassical economists of the late nineteenth century saw *satisfaction* ("utility") as the end of the economic process, not material outputs, and so the distinction between productive things and unproductive services, with productive and unproductive labour respectively, disappeared, although the classical economists' focus on material outputs has lingered outside the profession, influencing a range of thought, from the Soviet Communist planners in Moscow at one extreme to contemporary environmentalists at another.[1]

The modern framework, which evolved with the post-war introduction of national economic accounts, recognises three sectors: the primary sector consists of agriculture and mineral extraction; the secondary sector is composed of industries that transform materials in various ways; and the tertiary sector is a wide range of activities that produce "services," outputs which do not survive their production. Legal services are in the tertiary sector.

In 1965 William Baumol (1965) distinguished between activities that could experience increases in output per employee ("productivity growth") from those that could not. Such increases might occur because of the increased used of tools, or machines, or other inputs per hour of labour, which means that his distinction is rooted in the nature of the production process or technology that produced the output, rather than in the nature of the output itself. Primary and secondary sector production fall into the first (increasing productivity) group, while services production by and large falls into the second (non-increasing productivity). Where do legal services fall, and why is this of interest to us here?

A brief diversion into economic theory is necessary. If an economy has two sectors, one in which output per labour hour is rising (increasing productivity) and one in

1. And even in modern science fiction: see Douglas Adams (1980).

which output per labour hour is constant (constant productivity), then the average cost of production in the first sector will be falling compared to the average cost of production of the second sector. The earnings of the employees in the first sector will rise faster than the earnings of the employees in the second sector since the former are more productive than the latter. Whether the demand for the output of the second sector will support the higher costs will depend on the demand for this output and on the degree of competition in the provision of its output. In general, employment in the second sector will grow compared to employment in the first sector. These were Baumol's insights: although employment would rise proportionately in the second sector, so would its cost of provision.

Throughout the industrialised world, the data show that employment in the services sector (including legal services) has been the fastest growing of all sectors. This growth is partly demand-driven -- for instance, society demanding more policing, not least in the prohibition of illicit drug use -- but also partly because slower productivity growth in services will, with relative real output levels unchanged, cause employment to grow in services relative to other sectors, such as goods production, as Baumol's unbalanced growth model explains.

Here is another way of thinking about this. Consider activities such as university lecturing, live theatre, live symphonic concerts, hairdressing, and arguing for one's client in court. These are activities where it is difficult to reduce the hours of labour input by substituting, say, machines for people. As Baumol puts it, these are activities which have slow productivity growth. These are also activities whose costs are rising fastest, as their employees aspire to rising standards of living. In activities with faster productivity growth, employees' earnings can also rise, but substitution of machines for labour inputs means that the average costs of these activities may remain constant or fall even as their employees enjoy higher pay.

Unless services manage to find ways to improve their labour productivity, their average costs will continue to rise, even with no rise in their levels of activity, leading to issues such as that motivating this volume: the rising cost of legal services. A striking example of these rises in Australia has been premiums for medical malpractice insurance: it's not that doctors have been performing more negligently (although it may have been getting easier to find expert witnesses to testify against their professional colleagues), but that both a rising incidence of negligence suits and rising damages payouts have led to higher costs and so higher premiums.

Anecdotal evidence suggests that solicitors, even in small legal firms, have used word-processors to substitute for stenographers, mobile telephones and pagers to substitute for secretaries, legal search software on CD-roms and the Internet to substitute for legal libraries and researchers, all of which are ways of improving labour productivity. Indeed, in one large Sydney law firm, that ratio of lawyers to support staff has risen from less than one half to over two in the past thirty years, clear evidence of a significant improvement in labour productivity. (See Andrew Mowbray's chapter for further discussion of the possibilities.)

Bok (1993) focusses on the remuneration of lawyers in the U.S. -- he is particularly concerned about the incentive effects of the contingent fee system, one of the oldest forms of performance pay. But the system is open to abuse: overly zealous representation ranging from simple discovery abuse to supression of evidence and complicity in fraud or perjury, even if these last are rare. Sometimes it will suit a lawyer's interest to talk clients into continuing a suit in hopes of a larger reward even though they would be better

advised to settle immediately for a definite amount, or the opposite: persuading the client to settle quickly even though the client might do better to persevere in search of a larger recovery. For some kinds of accident compensation cases, a form of no-fault insurance would avoid litigation costs, lawyers' fees, and perhaps pain and suffering awards, thus reducing costs of settlement. Insurance already spreads to the cost of negligence, so incentives against negligence are already weak. For large legal firms acting for corporate clients, one response to rising legal costs may be to face demands from clients for them to set a fixed fee in advance of taking a case, instead of charging by the hour.

Reports into the Australian legal system, such as the Senate Standing Committee on Legal and Constitutional Affairs' *The Cost of Justice: Foundations for Reform* (1993), have called for microeconomic reform to be extended to the legal profession. As Bok (1993) points out, most potential clients know very few lawyers and have no way of judging their abilities. They seek out particular lawyers either because they happen to know them or have a friend who knows them or because they have found them in the telephone book. Most plaintiffs do not know whether they have a strong case. These "informational asymmetries" are reasons why a simple-minded appeal for greater competition in the legal profession may not result in more efficient outcomes.

Can the recent rate of improvement of productivity in the provision of legal services continue in the future? Will the bar exhibit rises in labour productivity similar to those observed for solicitors? If our expectations, as argued in thse pages, are realised, then there may be less litigation, ceteris paribus, but how can barristers become more productive? Incentives for shorter court hearings, and the greater use of computer technology in complex litigation are two possibilities. One thing is clear. Given dwindling levels of legal aid funding, and without further improvements in line with the average improvements in labour productivity across the economy, legal services will continue to become dearer and dearer, and so available to fewer and fewer, with a consequent loss of employment in the sector.

3. References

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